Global Fixed Income Thematic Viewpoint

HIROYUKI HIGUCHI
SENIOR PORTFOLIO MANAGER
HEAD OF FIXED INCOME AND CURRENCY

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Mitsubishi UFJ Asset Management (UK) Ltd.
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The gap between the market's expected economy and the real economy #2

In last month's report we looked at the divergence between the US economy as envisaged by the market and the real economy and how the market's expectations of interest rate cuts were more consistent with a recession. In summary that the economy was not as bad as the market was predicting, and that the likely outcome is a soft landing scenario based on improvements in labour productivity.

Nonetheless, when one Fed official after another expressed concern about the labour market and cut interest rates by 0.5%, we couldn't help but wonder if there was some data that they have access to that we do not. Particularly so when comments like this are made by officials with a practical approach to their mandate, such as Mary Daly of the San Francisco Fed and Bill Dudley formerly of the NY Fed. However, in his 3 October Bloomberg Opinion piece Bill Dudley dispelled this. His comments were broadly as follows:

That there is a possibility that we were overly pessimistic about the risk of a recession. The unemployment rate rose to 4.2% in the August employment statistics, but this was due to an increase in the working population, not the impact of layoffs. With regard to the Sahm Rule, that it refers to a statistical regularity, not an economic law, and there is a possibility that the reference value will be higher in a phase where the working population is increasing.
Finally, that there is a good chance of a soft landing, and in that case, monetary policy should be neutral rather than accommodative in which case the policy interest rate will not fall below 3.5%.

This is highly aligned with the economic situation we had envisaged and have discussed on various occasions since the start of 2024. There was nothing to indicate a substantive deterioration in employment, which was really the only thing the Fed was looking at. The neutral level of interest rates is unknown with a wide range of estimates but currently based on the strength of the economy, the housing market and the state of loans, we believe to be around the 4% level. The decision-making process for monetary policy appears to have become somewhat chaotic as we approach the US presidential election, making it even more difficult to time the market.

Finally, a comment on the deteriorating situation in the Middle East, particularly so with US Elections now just weeks away. From the perspective of Israeli Prime Minister Netanyahu, market commentaries suggest a preference for Trump, who has declared his full support for Israel. On the other hand, if a full-scale war with Iran were to break out and US support for Israel were to be weak, the Biden administration would lose the votes of Christian evangelicals. If that is the case, it would be advantageous for Netanyahu if a full-scale war were to break out before the election. Israel might invoke the Octopus Doctrine, which targets Iran as the head of the octopus as a means to weakening the tentacles as her proxies. If Iran is left isolated, it will lose Hamas, Hezbollah, Shia militia organisations and others it has nurtured over the past few decades, and will lose the means to oppose Israel in the future. Unfortunately, the situation is likely to deteriorate further and since crude oil is directly involved here, we think the impact on the market will be no less significant than before.

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