

## Global Fixed Income Monthly

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### Monthly Macro View

- The US forward market based on swaps currently sees short rates hitting 3 per cent (in line with the Fed estimate of long-term neutral) by late 2026. The forward curve using the treasury market has short rates settling at 3.5% which is in line with what market participants thought was the neutral rate. The US forward bond curve sees the yield curve (10yr minus 2yr) at around ninety basis points in one year's time which is in line with the long-term average. In short, the market sort of expects rates to be around neutral throughout the yield curve by end 2026; inflation bump over, negative impact on growth from tariffs over and everything where it should be. The background to that is what we have pointed out many times with regard to credit spreads being tight, namely on the private side of the US economy there just aren't any distortions which seem likely to cause an embedded downturn or for that matter a boom.
- What are the risks around this rather benign outlook? One is inflation. Tariffs will push it up and if the economy doesn't pull back then there is a risk that inflation expectations become entrenched and it becomes a harder battle to pull them back. Another is that views on neutral rates are not at all precise and it may be that rate is much higher or (more likely) lower than expected; only in September last year ten-year rates fell to 3.6 per cent as people saw hints of a slowdown which ignited thoughts of rates pre-Covid. There is also the shifts taking place in the American psyche as headed by Donald Trump; if American exceptionalism was based on its Constitution, rule of law, belief in science and spending on such, immigration bringing talent into the country, openness to competition, dislike of corruption and freedom of expression then that is being challenged. The impact will be slow moving and may be largely reversed, but it is something to note and ponder. Finally, there are government debt levels, which are outlined in the next section.
- Fiscal issues remain a burden on markets. There are two problems: the levels and the political backdrop. The levels are high but in most cases sustainable. The political backdrop is concerning. Wealthy countries can operate with high debt levels because, well, they are wealthy but also because markets see a reasonably well-educated population making sensible choices to elect politicians who will do sensible things. Sensible things include controlling debt levels, such as was seen after WW2 in the UK for example. The rise of populism is challenging this narrative. In the UK pressures for spending made the government change their fiscal rules and leave little spare room even with the new rules. With a populist party, Reform, gaining supporters it is very difficult to take hard decisions. In many Euro countries similar issues apply. Markets will rightly remain concerned unless they can have confidence debt levels will be tackled.
- All this plays into the idea of steeper yield curves. In addition, some of the arguments behind secular stagnation have gone; globalisation is significantly diminished, stronger banking regulations are being toned down, the rise in spending on defence and climate change are boosting demands for capital. Some remain: primarily lower productivity and ageing populations. This pushes up rates relative to the pre-Covid norm but not as high presumably as before the GFC. So we should be looking for rates somewhere in between these two levels but with a steeper yield curve structure.
- We still believe there is some value in bond markets and more in the higher yielding markets. Australia at the longer end we think has value given the far better fiscal position than elsewhere. We still think the UK is cheap because most other countries seem to be in similar predicaments but have much lower yields. We think the EU is poor relative value given the fiscal pressures it faces as well as the existential threats from high debt levels and the growth in nationalism. In the short term, however, the economic outlook is poor making the short to intermediate ends somewhat attractive.
- On the major currencies we remain largely neutral given the political risks and possible changes abrupt changes in policies.
- On spread we remain slightly positive. Fundamentals are robust and any softness in economies is largely down to government actions rather than excessive optimism causing distortions in either the consumer or business space. We would look to add on spreads moving notably higher.

# 1. Portfolio Positioning

- Rates and Duration

We are positioned on the premise that the actual impact of tariff hikes on the economy would begin to appear in macroeconomic indicators from summer onwards. However, corporate earnings were better than expected, and that companies were absorbing the initial impact of tariffs, with the possibility of a delay in the scenario over several months also considered. However, during our recent visit to the United States in June, signs of crowding out in commercial real estate were observed, and in anticipation of interest rate declines from mid-July onwards, duration was extended.

As expected, signs of a slowdown have begun to emerge in macroeconomic data such as employment statistics, private final demand, and residential and commercial real estate (see miscellaneous comments). We assume that short-term cycles are also having an impact in addition to tariffs. However, we do not anticipate a recession. We will maintain a longer duration policy with a target lower bound of around 3.6% for the U.S. 10-year interest rate.

In Europe, We maintain a neutral stance on short-term rates, in line with market pricing. The ECB held its deposit facility rate at 2.00% at the July meeting, with President Lagarde reiterating that the current level is appropriate given the inflation outlook. Longer term we maintain our short position on long term rates. The EU's current reliance on economic stimulus and increasing debt levels, now amplified by Germany's multiyear borrowing framework and Brussels' push for permanent joint EU bonds, without adequately addressing underlying issues, poses risks to credit stability and we hold a negative outlook for government credit risk.

UK long term gilts continue to offer value as domestic inflation moderates and monetary policy tilts dovish. The UK's term premium stands out as relatively high, and assuming credible fiscal measures alongside the BoE's cautious approach, this bolsters the case for a long duration stance.

In Japan, wage increases are indicating stronger inflationary pressures, and inflation caused by wage increases appears to be taking hold. Furthermore, Japan's political situation has become unstable following the election results, and we expect continued volatility in the near term. For the time being, we will maintain a neutral stance on Japan's interest rate strategy

We look to allocate risk to countries with potential for lower interest rates relative to the U.S., such as New Zealand. During the month, we increased both bond weights and duration in New Zealand, and currency positions were neutralised through cross-hedging. The country, which has a strong economy and is AAA-rated is facing higher interest rates than the United States due to global interest rate hikes and supply-demand factors.

- Currencies

While largely neutral, we look to overweight countries with relatively stronger positions in trade wars and geopolitics, and manage positions centred on euro underweight versus Norway, Sweden and Poland, and China underweight versus the U.S. There is a possibility of a ceasefire in the Russia-Ukraine war, and we anticipate positive results from our Poland overweight position.

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