MUFG Asset Management

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HEAD OF INVESTMENT

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Mitsubishi UFJ Asset Management (UK) Ltd.
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Monthly Macro View

- The war remains highly uncertain. The US presumably regrets ever starting it, Iran thinks it has leverage and can negotiate very hard and Israel is very keen to continue it. Analysts are divided on where it is going.

- Inflation has persistently been above target in many areas for a considerable period. This has been largely due to shocks and Central Banks have largely looked through it. That has been the correct response. Yet as the Bank of England member, Catherine Mann has pointed out there is a good risk that long periods of inflation can lead to 'persistence'; price setters start assuming higher inflation is more likely. This has been much debated in the UK, but US markets are also showing some signs of adopting this as a risk. Thus far measures of expectations have, until very recently, not shown this strongly and neither have wage settlements. Yet given the weakness of the US institutional framework there is some rational basis for this, and markets are right to worry about it. Fortunately, the new Fed chair took a tougher line than had been expected, which was positive.

- Fiscal issues remain a concern. There is still nothing to see among the general population or the political class to start to control this. It is not an immediate threat, but long-term forecasts are dire and risk premia should and to an extent do reflect this and will continue to do so.

- Taking into account the very abrupt turn in the nature of the United States remains challenging. The effort to turn it into an autocracy, the attacks on individuals and institutions, the reversing of long-held norms by the Supreme Court, the corruption, the failure of the rule of law, the abandoning of the global democratic alliance system, the concentration of extreme wealth to a level not seen since the late nineteenth century and the turning against science and immigration are clearly profound events. The impact on markets has not been anything like these shifts. The equity market has benefited from AI excitement and the ability of companies with strong moats (i.e. a lack of competition) around them to finance data centres without too much strain. The share of the GDP being to capital has been rising, which is clearly positive for earnings. The ability to increase stock buybacks relative to dividends has also been important given tax considerations as has increased gearing. For bonds most of what is happening should increase risk premia to some degree; it is less certain one can trust the United States to pay one back, the inflation targeting is more likely to be challenged and debt metrics are not high in populist regimes.

- Pre-Covid interest rates were very low and Larry Summers coined the term Secular Stagnation to explain this. The argument was there was too much saving (demographics, rising inequality) and too little investment (slower productivity, less capital-intensive cost technology, regulatory banking changes that raised the cost of capital, integrated global supply chains increasing competition). The question is: how much of this has changed? Demographics not at all and inequality has risen. Everything else, though, has shifted away from secular stagnation. It is reasonable, therefore, to see higher interest rates as permanent. From a historical perspective they remain quite subdued, which given the importance of demographics may well be reasonable. However, it appears we are settling into a period where current levels are seen as the norm.

- Currencies are dependent on the war as well as the relative strength of the US economy. We were long AUD before the war and would continue with that. Otherwise, we have little conviction. The US benefits from being an oil exporter and a safe haven if the war worsens, but it is increasingly isolating itself internationally and is becoming less trusted. Its debt situation is also troubling in that there is no sign any party wants to control it. Its policies are diminishing rather than enhancing its huge fundamental strengths. Finding the alternative, though, remains troubling. On the other side the economy is proving more resilient than expected which is increasing the short-term attractiveness of US interest rates.

- Spread remains tight. Healthy corporates, little sign of concentrations of risk and less trust in governments are all likely contributing to this. Disillusionment with AI hopes could damage this, but it is not a main scenario. There is therefore little reason not to keep a low profile.

Portfolio Positioning

- Rates and Duration

  While the mood regarding the situation in the Middle East was initially optimistic following the ceasefire agreement, we do not believe the risks have subsided. We view it as highly likely that tensions will escalate again around September, when the negotiation deadline approaches. In addition, prices for DRAM (memory) and semiconductors are rising due to demand from AI data centres. Given that the U.S. economy remains resilient thanks to a premiumization strategy targeting the affluent, this is expected to fuel inflation on both the demand and supply sides. Therefore, we base our strategy around the risk of a resurgence in inflation, placing greater emphasis on this risk than the market consensus. We plan to maintain a neutral to slightly long duration, pursue a flattening yield curve, and focus our bond allocation on resource-rich countries such as Norway and Australia. Given the economic environment described above, the distance to default may shorten for certain issuers; therefore, when spreads widen significantly, we plan to increase our weighting in high-credit-quality issuers.

  We have made slight adjustments to our basic strategy from the previous month. As mentioned above, we view it as highly likely that tensions in the Middle East will escalate again. On the other hand, the market consensus is that the impact on energy supplies will be limited, and there is currently no information to contradict this view. Therefore, while respecting the market's assessment, we are managing our positions with caution regarding a potential resurgence of inflation concerns. Duration is neutral to slightly long, the yield curve is flattening, and we are continuing our allocation focused on resource-rich countries. Regarding duration, we are maintaining a longer position in Australia and New Zealand—which are less susceptible to energy impacts and have relatively limited room for interest rate hikes—while maintaining a shorter position in Europe, which is more vulnerable to such impacts.

  In Euro area, we maintain a neutral stance on short-term rates, broadly in line with current market pricing, which now assumes a July pause and centres the next hike on September. At its most recent 11 June 2026 meeting, the ECB raised all three key rates by 25bp, taking the deposit facility rate to 2.25%, with President Lagarde stressing a data-dependent, meeting-by-meeting approach, describing the decision as "robust across a range of scenarios" and explicitly rejecting the "insurance hike" framing, while warning that the Middle East war is generating inflation pressures alongside downside risks to growth; since then, the June flash data have validated a pause as headline inflation has eased from its May peak by more than expected, services inflation has cooled from sticky levels, and underlying pressures have narrowed rather than broadened; though this week's renewed US–Iran escalation puts that improvement immediately at risk.

  In the UK, market volatility in gilt yields remains notable, driven by the re-escalating energy shock and hawkish rate repricing. Even so, long-term gilts continue to offer value as domestic inflation should moderate if the shock fades, sitting below a curve that now prices hikes and no near-term cuts. The Debt Management Office's reduced long-dated issuance remains a technical tailwind, reinforced by a shift toward T-bill funding and a Financial Policy Committee's review of gilt treatment in bank leverage ratios that could unlock structural demand, though partly offset by still-large supply, QT and weaker fiscal execution after April–May borrowing overshot the Office for Budget Responsibility profile. The UK's elevated term premium still appears to compensate, provided the energy shock stays a relative-price rather than persistent wage-price dynamic.

  In the Japanese government bond market, there is a risk of further yield increases. Expectations that the Bank of Japan will continue to normalize monetary policy remain strong, while buying pressure from domestic institutional investors appears to have weakened. In particular, demand from life insurance companies and pension funds is becoming less reliable as a stabilizing factor for the market, given current yield levels and rising volatility in the ultra-long-term sector. As a result, Japanese government bond yields could rise further, particularly if inflation expectations remain firm and the Bank of Japan maintains a relatively hawkish stance.

- Currencies

  As previously mentioned, we currently have no strong view on currencies except that we are short Chinese Yuan vs USD. We maintain a modestly bullish view on AUD because of the divergence of monetary policy between Australia and the US.

  The yen is expected to remain under downward pressure for the time being. Rising crude oil prices are heightening concerns about Japan's trade and current account balances, and the still-wide interest rate differential continues to exert downward pressure on the yen. Although the government intervened in the FX market as expected, we do not believe this will fundamentally alter the underlying trend of yen weakness in the short term. Rather, the intervention is likely to slow the pace of yen weakness and curb disorderly movements, but it will not completely reverse the trend.

  That said, the risk of further intervention remains significant. If the yen's depreciation accelerates again or exhibits disorderly movements, there is a real possibility of additional intervention, which could trigger a sharp but temporary appreciation of the yen.

Important Information