MUFG Asset Management

Global Fixed Income Monthly

GARY HUTCHINGS
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

- Trump is clearly a vital factor is markets, but continuing to solely focus on this becomes repetitive and stale so here will be a brief but hopefully clear summary. Trump promotes economically illiterate policies, he does so in a chaotic fashion and he appears to want to follow the autocratic playbook as demonstrated by Victor Orban in Hungary. Examples are tariffs, budget policies, ignoring the standing of Congress in spending, firing of civil servants who are not sycophantic, attacks on the judiciary and a host of smaller acts. The impact on markets is greater volatility given there is no idea what is going to be thrown out next or whether it will last and less faith in what had been the bedrock of confidence in the US (the Constitution, the Rule of Law, belief in science, rational policy making) causing risk premia to rise.

- The strange phenomenon of voters voting for damaging populist or nationalist parties is not limited to the US: AFD in Germany, Le Pen in France, Nigel Farage in the UK and so on. Even without these parties coming to power they inhibit through social media hard but sensible policy decisions being made. At a time where budget deficits need to be controlled, ageing populations are challenging, climate change needs action, and low productivity reduces fiscal space lack of rigour in policy is another factor pushing risk premia higher. A lack of seriousness now leads to much greater problems later.

- The UK is an example of this. Brexit clearly made the country poorer and equally clearly people are unhappy about the provision of public services even at a time when the tax take as a percentage of GDP is the highest since the 1940s. Yet this unhappiness is promoting the rise of the Reform Party which is the group which pushed very hard to make people poorer through Brexit. That party is now gaining in popularity and is pushing for tax cuts and higher government spending at a time of a very high debt/GDP ratio and a high government deficit. A decent percentage of the population for reasons that are not fully understood do not understand the problem here and to retain these disenfranchised voters the government is being forced to some degree to accept their ‘ideas’. This creates tensions with markets which are sensible and are worried about the current fiscal stance and the vaguer threat of what kind of political regime will hold in the future. If such reflects angry populist population desires, then there are legitimate concerns about a current thirty-year government bond repaying.

- All of 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 therefore 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 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 somewhat 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 above their long-term average level.

2. Portfolio Positioning

- Rates and Duration

  Following the turmoil caused by the triple decline in US assets in April, the market has stabilised, although US interest rates have risen amid downgrade news and concerns about fiscal deterioration.

  Overall, at this point, we remain comfortable with our mild long duration position in the US, believing that the effect of a near term slowdown in the US economy will crystallise before the medium-term inflationary picture becomes clear (whether sustained or temporary). With future increased public spending in Germany likely to increase bond issuance, we maintain a tactical short at the long end.

  Longer term, the current dismantling or undermining of many institutions that have underpinned the strength of the US economy for decades, is a clear negative. Following the turmoil caused by the triple decline in US assets in April, the market has stabilised, although US interest rates have risen amid downgrade news and concerns about fiscal deterioration.

- Currencies

  The foreign exchange market has remained volatile, prompting us to manage risk cautiously.

  In response to the weakening dollar, we underweighted currency groups highly correlated with the dollar (dollar, China, Canada, etc.) relative to currency groups highly correlated with the euro (euro, Sweden, Norway, Poland, etc.). In May, as non-government bond spreads tightened, we reduced weights again (from 15% to 13%) to lock in profits. As spreads tightened further, we sold JP Morgan and Polish government-affiliated financial institutions and added high-quality Rabobank.

  We believe that the tariff war will lead to a deterioration in real economic indicators around June to July and we will maintain a longer duration policy, targeting a US 10-year interest rate of around 3.6%. Regarding foreign exchange, we will focus on countries with advantages in trade wars and geopolitics, with a core strategy of euro underweight/Norway, Sweden, and Poland overweight, and China underweight/U.S. overweight.

Important Information