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1. Monthly Macro View

- It is usually impolite to talk about politics, primarily because it can make people very angry. With what is currently going on, however, it is difficult to avoid. It is best to be disinterested and focus on market impacts. Yet the long term shifts are potentially profound and one's background as well as personal views are bound to colour things. So whilst I use the term 'we' here my own take is clearly present. I apologise if this take clashes with your own - I have tried to avoid it.

- We have previously often mentioned politics. It has now entered the forefront of the debate. Putin's aggression has finally provoked the EU into grasping the threat to them, the US is withdrawing from the post-WW2 'free world' consensus, the Far Right everywhere are a great cause for concern and Donald Trump in the White House is to say the least highly controversial.

- Concentrating on Trump. If you were brought up in a liberal democratic tradition you will find Trump difficult simply because he is breaking it. The move is so profound it is difficult to describe in a few sentences, but we will try.
The international changes: from 1945 the US foreign policy has been directed at promoting liberal democracy which would benefit the US through long term peace and through trade. Whatever the US is supporting now, it isn't that. It has treated its closest allies with contempt (calling the Canadian PM 'Governor', saying it will take Greenland by any means necessary, actively promoting far right parties in Europe, supporting Russia, abandoning USAID). Some is inevitable: Europe did not spend enough on defence, the US is no longer as powerful as it was (share of world GDP in PPP terms was 22% in 1980 and is 14% now). Yet the abruptness and savagery in the language of the change and complete turn in alliances suggests an ideological shift. As ever, though, it is hard to know how much intellectual heft there is behind this relative to a narcissist bullying businessman somehow obtaining power. It is really difficult to understand how cheap energy being supplied to the US by Canada could possibly be described as the US subsidising Canada.

    - Market impacts from Trump International:

  Tariffs – negative for growth everywhere but less so for US than others, pushes inflation up in US short term, less competition means less efficient economies. Other things being equal, short rates in US cut less quickly as inflation rises but later growth impact should push rates down again, other countries should see lower rates given greater growth hit. US alliance shift: greater threat from Russia means European defence spending up which if funded by borrowing means higher rates, support for right wing parties threatens EU and creates high political uncertainty which should raise risk premia. Collapse of US aid means greater poverty and higher risks of transmission of infectious diseases. Emerging markets: lack sufficient expertise to properly comment.

    - Trump USA:

  Many serious commentators are talking about a coup: bypassing Congress which has the sole authority to appropriate money, appointing people loyal to Trump rather the US (the head and deputy head of the FBI, changes in the military, the removal of the military's top judge advocates general - they have the independent legal authority to tell any military commander or political appointee that an order from the president or the secretary of defence is unlawful, cannot be given, and should not be obeyed), controlling the press (either being bought – Washington Post, X, Meta – or threatened – AP exclusion, the first time in a Century this has happened), attempted control of the judiciary, ignoring the judiciary, Vance stating the Executive should simply ignore judges' directions, unelected and unvetted people (DOGE) given access to US citizens private data. Then there are the fears over corruption with Musk interfering and neutering US Government Agencies who were investigating him and Trump setting up his own crypto currency. I suppose the easiest way to think about it is that when he last lost the election he tried to prevent being ousted: he knows what went wrong last time.

  The problem is in understanding what the domestic agenda actually is. General tariffs make no sense, reducing illegal immigration is hardly a startling economic realignment (albeit inflationary if successful), making government less wasteful is interesting (but which government doesn't want to do that?) but unless it actually means shrinking what it provides it is unlikely to yield much. In general it appears there is an emphasis on entrenched business interests, making the rich richer and cutting benefits to the poor. Perhaps despite all the chaos he ends up not actually doing much economically.

So Trump the mastermind or Trump the not so clever chaotic bullying wrecking ball?
An interesting point is his voter base. The red states are the poor ones and the blue states the wealthy ones. The more educated you are the less likely you are to vote for Trump. His largest support group are poorly educated white men. The question is whether and how long will it take them to figure out he is making them worse rather than better off?

As the Nobel Laureate Paul Krugman put it:
'Yes, I'm aware that if you point out that red-state residents are voting against their own interests, you'll get attacked as a liberal snob who thinks "real Americans" are stupid. No, I don't know how to get past that. But it is the truth.'
For markets: Trump inherited a great economy, tariffs will push up inflation which will be temporary and push down growth which will be permanent. A move from a liberal democracy and more towards a dictatorship has historically simply been damaging (populist governments hitting growth over the long run by around 15% of GDP). In some ways we can think of it as what made America great: its Constitution, belief in the rule of law, belief in free markets/competition and its optimism. However Trump talks about MAGA his policies pursue the exact opposite of what America used to stand for. Many still do stand for it but they lost the election. If it continues the US over the long run will be poorer.

- Squashing everything else. Fiscal issues remain prominent. At a time of full employment deficits should be pulled back. It isn't happening which is bad for bonds. In Europe, if you want to raise defence spending you should raise taxes: they aren't. That raises long term issues of debt repayment and short term issues around inflation. Politics remains an issue: the far right remaining popular mean that faith in sensible policies prevailing in the long run is diminished. Although low productivity growth and demographics remain to put downward pressure on interest rates in the longer run, other dynamics have shifted. The move to tariffs, the increased power of extremely large companies reducing competition, more talk about deregulation of finance push in the direction of higher inflation pressures and higher real interest rates.

- As for markets: the US economy was very healthy (possibly too healthy) tariffs and immigration policies will push inflation up but at the same time slow the economy. So short term yields should be kept restrictive but as the inflation effect fades and the growth impact comes through there should be room to bring rates down. In the EU higher fiscal spending should push rates up and the convergence we expected with the UK looks as if it will come more than we previously thought from EU rates rising. Japan we think is in a structural bear market. As for currencies we remain rather neutral with the dollar positives from rates being mitigated by the fiscal spend from the EU (if it comes through). We are positive on the Yen. The US equity market looks too high by at least twenty per cent so there are obvious risks here, such risks being positive for rates but not for spread.

- With increased uncertainty but still positive economic outlooks spread remains decent value, but we had pulled back a little and will retain a modest long position.

2. Portfolio Positioning

- Rates and Duration
  The US economy continues to grow at or around trend, supported to date by strength in the consumer. The gap between the size of the US labour force and available jobs has closed. Wage growth is judged consistent with the Fed's inflation target. Despite this, it is hard to escape the fact that a downward trajectory in core inflation remains dependent on a softening in housing costs.

  The Fed's bias towards cutting rates remains, albeit at a more measured pace. It is clear that any sign of significant weakness in the job market will see further reductions, beyond what is currently priced in. Given rates remain elevated relative to what both the Fed and most market participants view as "neutral", we continue to see value in the long run.

  Neutral Outlook on Short-Term EUR Rates: We concur with the market's pricing of ECB rate cuts, given the current economic weakness and the potential imposition of U.S. tariffs on European goods. However, several factors could influence the timing of these cuts: Persistent inflationary pressures, particularly within the services sector, may delay or moderate the pace of rate reductions. Alternatively, rates might need to be lowered more aggressively given structural economic challenges.

  We remain long duration in the UK, where underlying challenges remain, including productivity issues and a persistent current account deficit. The Autumn Budget 2024 introduced expansive fiscal measures designed to stimulate growth and improve public services. However, funding these measures through increased borrowing and higher business taxes poses significant execution risks and rising debt servicing costs have nearly eroded the Chancellor's fiscal headroom, leaving little flexibility for additional spending and heightening the risk of forced fiscal tightening if growth falls short. Recent market indicators suggest a modest stabilization in gilt yields, reflecting cautious optimism as the Bank of England signals a measured easing of its policy stance.

In Japan, we have changed our outlook from bearish to neutral/ slightly bullish. Japan's inflation and wage data continue to exhibit stability. While the Fed and ECB are in a cycle of rate cuts, we expect the Bank of Japan to continue raising rates, particularly given underlying fundamentals and we expect several rate rises this year.

- Currencies
  The Trump-Zelensky meeting ended in failure, and the European Union will support Ukraine. This is a historic event. It means that the ratio of the US, which bears 70% of NATO's military spending, and Europe, which bears 30%, will change. While there will be downward pressure on US interest rates in the form of a fiscal premium, this will encourage an increase in European interest rates

  In the short term, the euro is likely to strengthen due to higher interest rates, but in the medium to long term, we expect Dollar strength. We continue to hold Polish zloty, Swedish krona and Norwegian krona which will work in our favour in this framework, as well as US dollars and Chinese yuan. We are bearish on the Canadian Dollar due to low short term interest rate differentials and FX risk premium.

Important Information