MUFG Asset Management

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Monthly Macro View

- The US forward market based on Fed Funds futures currently sees short rates hitting 3.0 per cent (yes, in line with the Fed estimate of long-term neutral) by early 2027. The forward curve using the treasury market has short rates settling at 3.5%. Therefore, a recession is not seen, the inflation bump is looked through with the additional spice of something of a soft economy easing worries of inflation persistence enabling interest rates to fall to neutral expectations. 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.

- The rest of the world isn't really adding much positive to that narrative, although it looks more soft but stable than anything else. China remains burdened with real estate problems; Europe is fundamentally weak but likely supported by a fiscal boost. Emerging nations seemingly are going to struggle with competition from China and need to re-orient their economies from export driven to domestic demand as globalisation steps back. There is nothing that interrupts a broadly 'steady as she goes' theme.

- 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. Markets should be concerned unless they can have confidence debt levels will be tackled. The problem is likely greater than currently discounted, but the Dornbusch saying 'In economics, *things take longer to happen than you think they will*, and then they happen faster than you thought they could' also applies here. It is more a case of trying to anticipate the trigger point than waiting potentially for years for significant moves. Worrying about Italy and maintaining a short position is a case in point - several years of losses.

- The changes in US policy also remain challenging. The move toward Authoritarianism and the move away from science (attacks on universities, reduced funding, quacks being put in charge of health) are productivity negative. Several years of brinkmanship on the debt limit, statements that not paying your debt back is fine, senior advisors talking about turning short term bonds into one-hundred-year ones is not a positive backdrop for US Treasuries. Having asserted hire and fire rights by the supine Supreme Court over most US Agencies President Trump has now turned his attention on the Federal Reserve. In any other country these events would have caused a flight to safety. It speaks to the historic fundamental strength of the US economy (based on its institutions) that the reaction thus far has been modest. It must, however, remain of considerable concern. It should be noted that at least part of the reason for the strength in the gold price is likely down to a shift toward mobile wealth as some traditional safe havens have just become less safe from a political point of view. Hopes surrounding AI on the other hand remain supportive of growth and US strength.

- All of this plays into the idea of steep 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. Tariffs should push the dollar up but other policies are poor for the economy.

- On spread we remain on the positive side of neutral. 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. Our positioning is slight given historically tight spreads, the fiscal backdrop with populism preventing sensible policies being pursued and with the risks of populists gaining power and embarking on damaging (potentially very damaging) policies.

Portfolio Positioning

- Rates and Duration

  Under the current US employment conditions, downward pressure on interest rates is expected due to the negative economic impact. However, US rates may see limited declines due to widening risk premiums. Therefore, the strategy is to adopt a longer-term approach, focusing on countries with significant room for rate cuts, such as New Zealand and Australia. In phases where non-government bond spreads widen due to economic slowdown concerns, the strategy is to increase the weighting of high-quality non-government bonds, such as government-guaranteed bonds and state bonds.

  In Euro, we maintain a neutral stance on short-term rates, in line with market pricing. The ECB left its deposit facility rate unchanged at 2.00% at the September 11 meeting, with President Lagarde highlighting that the economy is “in a good place” and that the stance remains flexible and data dependent.

  In the UK, the economy continues to face ongoing structural and cyclical challenges, notably subdued productivity, persistent service-sector inflation, and global trade disruptions (exacerbated by new U.S. trade tariffs). Long-term gilts continue to offer value as domestic inflation moderates from its peak and monetary policy leans cautious-dovish at the margin. 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, we have shifted our stance from neutral to slightly bullish. In the FX market, we anticipate the dollar-yen rate moving towards yen appreciation from the 150 yen level. On the interest rate front, we look to a flattening position on the yield curve.

- Currencies

  We continue to focus on the economic spillover effects of the Trump administration's economic measures and shifts in money flows driven by geopolitical risks Contrary to market expectations, the Russia-Ukraine war may see movements towards a ceasefire. With the deterioration in US employment now widely acknowledged, downward pressure on the employment environment and consumer behaviour is anticipated. The underlying trend is dollar weakness, but we anticipate a seesaw effect against the backdrop of European political turmoil.

  Accordingly, we are underweight dollar-area currencies versus euro-area currencies, while closely monitoring global developments. This will involve positions such as overweight (OW) on peripheral European countries like Poland versus the euro UW, and overweight US and Mexico versus China UW.

Important Information