MUFG Asset Management

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Monthly Macro View

- The US forward market based on swaps currently sees short rates hitting 2.8 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 3.3% which is around 20bp below the level before the latest employment data. Therefore, a recession is not seen, the inflation bump is looked through with the additional space of something of a soft economy easing worries of inflation persistence enabling interest rates to fall to the lower end of current 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. 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. Again, though 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 will rightly remain 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. Hopes surrounding AI on the other hand remain supportive of growth and US strength.

- 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 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 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. Our positioning is slight, however, given the fiscal backdrop with populism preventing sensible policies being pursued and with the risks of populists gaining power and embarking on damaging policies.

1. Portfolio Positioning

- Rates and Duration

The impact of tariff hikes on the real economy is expected to begin appearing in actual macroeconomic indicators from the end of summer onwards.

Overall, at this point, we remain comfortable with our long duration position in the US, believing that the effect of a near term slowdown will crystallise before the medium-term inflationary picture becomes clear (whether sustained or temporary).

In Euro, we maintain our neutral stance on short term rates but on long rates, we retain our short duration stance. While the ECB has largely completed its cutting cycle, structural drivers continue to push term premia higher.

In the UK, long term gilts continue to offer value as domestic inflation moderates from its peak 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. We maintain our neutral view on Japanese rates.

Elsewhere, we maintain a modestly bullish view on Australian rates. In New Zealand, with its sound fiscal position and comparatively weaker economic performance relative to the US, has higher interest rates than the US due to global rate hikes and supply-demand factors, we increased bond weightings and duration, while neutralising currency exposure via cross-hedging.

- Currencies

While largely neutral, we maintain an overall underweight position in dollar-area currencies 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.

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