MUFG Asset Management

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Monthly Macro View

- War-war not jaw-jaw. A completely pointless war that shows no sign of ending soon. The impact thus far has been to elevate inflation somewhat and to diminish growth to some extent, albeit less than many had thought likely. Bond yields are therefore more elevated, Europe must be concerned about winter given low LNG storage and China is presumably enjoying America's diminishment.

- 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 at some point and particularly with economies holding up there are obvious upside risks or at least risks that expectations become embedded. Thus far, though, the de-anchoring of expectations remains just a risk.

- The erosion of US institutions is a concern. A President who thinks trade unnecessary and implements that view without any check. A Health Secretary who believes vaccines don't work. The appointment of officials based on absolute loyalty rather than qualifications for the job. If you erode faith in government, it isn't likely to make sentiment toward the bond market 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. The future will be more challenging with ageing populations, the costs of climate change and presumably the risk that large fiscal spend may be required if facing economic shocks. Quite a lot is resting on AI productivity growth coming to the rescue.

- 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. If two per cent inflation is likely to be the norm going forward, some bond markets represent good value.

- 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, a safe haven if the war worsens and the economy has remained very resilient, 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. There is no clear alternative, though.

- 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 but positive profile.

Portfolio Positioning

- Rates and Duration

  While the situation in the Middle East is expected to be a protracted conflict, tensions with Iran may escalate ahead of the U.S. midterm elections. Additionally, September is a season of heightened volatility, as interest rates tend to rise due to deteriorating supply-demand conditions caused by bond issuance, and risk assets are prone to weakness. Since natural gas reserves needed for heating in Europe are at low levels, we expect interest rates in Europe to rise more easily than in other regions. We plan to maintain a neutral to slightly long duration, focus on the short end of the yield curve to generate carry while keeping curve risk low, and allocate bonds primarily to resource-rich countries such as Norway and Australia. We expect to increase our credit weighting during periods when credit spreads widen due to bond issuance in September.

  Our basic strategy remains the same as last month. The renewed tensions in the Middle East are largely in line with our expectations. While the market is finally beginning to recognize the impact of high energy prices on inflation, we believe there is still a long way to go. While persistently high energy prices could begin to affect long-term inflation expectations, leading to further interest rate hikes, an increasing number of countries are seeing 10-year yields hover around 4–5%. Given the impact of high interest rates on the economy, we view the upper limit for interest rates as around 5% for the time being. Therefore, we are managing the portfolio with a duration ranging from neutral to slightly long, focusing on the short end of the yield curve to generate carry while keeping curve risk in check, and maintaining an allocation centred on resource-rich countries. Regarding duration, we will maintain a longer stance for Australia and New Zealand—which are less susceptible to energy price fluctuations and have relatively limited room for interest rate hikes—while continuing to manage Europe, which is more vulnerable, with a shorter duration.

  In Euro area, maintain and reinforce a neutral stance on short-term rates, broadly in line with current market pricing, which now carries the deposit rate to 3.00% by mid-2027. The 10 September decision has not been taken as we write; a 25bp move to 2.50% is fully priced. At its 23 July meeting the ECB held all three key rates at 2.25%, its accounts recording that some members would not have opposed a hike and that insurance moves are no longer ruled out. Market implied policy rates continue to reflect two distinct forces; on the hawkish side, the energy shock has pushed headline inflation to a fresh peak for this episode, activity has been firmer than assumed for a third consecutive quarter, and the Council's own estimate of neutral is drifting upward; on the dovish side, the ECB's staff still read the shock as cost-push, wage settlements have decelerated further, core and services inflation both eased in August, and second round effects remain undetected.

  In the UK, market volatility in gilt yields remains notable, with long-dated yields at a level last seen in 1998. Even so, long-term gilts continue to offer value and the compensation has improved; the rise is judged term premium rather than a higher expected policy path. Slowing QT skewed away from the long end and the lightest net duration supply since 2021 add a technical tailwind. The risk is that the premium proves structural, in which case the long end stays cheap for longer than we assume.

  In the Japanese government bond market, upward pressure on yields is likely to persist. The market continues to price further monetary policy normalization by the Bank of Japan, while recent fiscal developments have increased concerns about future government borrowing requirements. At the same time, reduced purchases by the Bank of Japan and weaker structural demand from domestic institutional investors are increasing the amount of duration risk that private investors will need to absorb. Consequently, we expect term premium to continue rising, particularly in the long end of the curve, leaving Japanese government bond yields biased higher.

- Currencies

  As previously mentioned, we remain broadly neutral on currency although we maintain a modestly bullish view on AUD because of the divergence of monetary policy between Australia and the US.

  Japanese Yen, structural headwinds for the yen remain firmly in place. Japan continues to face unfavourable terms of trade due to elevated energy prices, while wide interest rate differentials encourage capital outflows. Although the authorities have intervened in the FX market, intervention is unlikely to change these underlying fundamentals. Instead, it should primarily be viewed as a tool to smooth excessive volatility rather than reverse the broader depreciation trend.

  Additional intervention remains a meaningful risk if the pace of yen depreciation becomes disorderly. However, unless accompanied by a material shift in monetary policy or narrowing global rate differentials, any intervention-induced appreciation is likely to prove temporary. We therefore continue to expect the yen to weaken gradually over the medium term.

Important Information