MUFG Asset Management

Global Fixed Income Monthly

GARY HUTCHINGS
HEAD OF INVESTMENT

30 JUNE 2024

Mitsubishi UFJ Asset Management (UK) Ltd.
A member of MUFG, a global financial group

1. Monthly Macro View

- Inflation data has come down into a better zone but it remains too high. Whether it falls happily to target and stays there or lingers over time above and requires interest rates to be restrictive for longer is a question which will be determined by how resilient economies are.

- On the whole economies, in terms of growth, appear to have moderated somewhat. There is residual strength from falling inflation and higher wages, which should support activity. Nonetheless, in many areas growth is mild and it is persistent inflation that remains the challenge. At the same time, unemployment remains low and the risks are two-sided: further slowing could cause resilient employment to suddenly reverse, alternatively the current relatively slow pace of growth could firm making improvement on inflation more troublesome. At the margin, we think the slower growth story has more credence.

- Where we have more conviction is where rates will ultimately end up. Whilst we recognize that higher government deficits likely require a higher real rate and that AI provides the prospect for higher productivity nonetheless, comparing with previous periods, it seems likely to us that a real rate of between one and a half and two per cent for ten year bonds is a reasonable range given the backdrop. This is higher than the rate since 2018, but lower than previous periods where inflation was more entrenched, productivity higher and demographics significantly more favourable. This makes some bond markets somewhat attractive at current levels from a value perspective.

- Politics. This is an area which can clearly alter outlooks. In the US a Trump victory would likely raise trade barriers which would raise price pressures. In France there is the risk of fights with the EU over fiscal policy as well as a resistance to the long term goal of further integration: neither happy for the EU nor for France. Therefore, the political issues that have plagued markets since Brexit look set to continue is some areas. We remain aware of the risks, but navigation of them is challenging.

- We think spread product remains decent if not outstanding value. Historically spreads are tight, but the background is positive. Corporate and private balance sheets are strong, the financial industry is well regulated and for the first time in a long time if economies slow there is room to cut rates. Inflation has moderated and expectations are well-anchored so the risk of a forced recession has considerably. Over time therefore spreads offer positive returns albeit we don’t see them marching strongly. Financials are good value versus Industrials given the currently unusual spread differential between them.

- Currencies: like fixed income currencies will be very sensitive to any signs of continued economic strength or any sign monetary policy is turning things around. Given the resilience of the US economy it would appear the Dollar will retain its strength. Rates in the UK are high and with a likely fiscal boost should be supportive although in the long-run, Sterling is vulnerable due to a fundamentally weak economic background.

  The euro area has lower rates and although somewhat firmer economic conditions may sustain the euro, the interest rate differential should favour returns from higher yielding currencies. JPY will struggle given a relatively weak economy, the current need to keep rates low to anchor inflation, large interest rate differentials and poor productivity. However, the Yen has fallen a long way and data surprises could lead to sharp reversals.

  Some of the minor currencies are of interest: we like Poland from a long-term view given secular changes to the economy. Mexico we like from a structural perspective, but politics is a severely limiting factor.

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2. Portfolio Positioning

- Duration
  The economic outlook remains unchanged, and considering the strength of US stocks and the economy, it remains likely there may one or even no rate cuts (please see our March Thematic update; *"Global Fixed Income Thematic Viewpoint - Divine Influence and US Interest Rates – where will they settle?"* where we discuss why the market was too optimistic in expecting multiple rate cuts).

  CPI will also remain flat at around 3%. On the other hand, we do not expect CPI to accelerate again due to improved productivity.

  Therefore, we expect the US ten year to move in a range of around 3.8-4.7% (core 4.3-4.5%).

  Duration will be adjusted within this range, but the main strategy is currency country allocation.

- Currencies:

1. We do not have a strong sense of direction for the euro/dollar because we expect the European and US economies to continue to be assessed. Therefore, we operate the ratio of currencies highly correlated with the dollar zone and currencies highly correlated with the euro zone at around neutral.

2. Among them, we plan to OW Poland, Australia, and New Zealand, which have relatively strong economies and high interest rates, and UW EUR. With the end of the US and European interim financial results in June, it is highly likely that trends will begin to emerge for these currencies. If signs of a trend emerge for the aforementioned currencies, we plan to further expand our positions and take on risk.

3. We are not bullish on the US dollar, but we believe that there is a high possibility that it will have a high carry and outperform the highly correlated Chinese yuan, which would lead us to overweight the US Dollar vs Chinese yuan.

- Spread:
  Long and again on value considerations. Not looking for substantial spread compression, but for carry to prove positive. Both consumers and corporates have strong balance sheets so this should limit downside even in an adverse economic situation.

  Equally, we think a boom requiring much firmer monetary action is also a remote likelihood. The latter has been rendered less likely given tamer inflation. Nonetheless, we are underweight cyclicals. We are also long Financials versus Industrials given the robust balance sheets of major banks and the current wide spreads between the two sectors.