MUFG Asset Management

Global Fixed Income Monthly

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HEAD OF INVESTMENT

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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. The latest US employment data, whilst far from being a decisive break, do show that it will be difficult to judge if things have turned and even if they have whether a soft or harder landing will be the result.

- The narrative thus far is that as higher real wages come through consumption will firm up. However, some central bankers have suggested we might be at a tipping point. Monetary policy is restrictive and has ensured the surge in inflation caused by the Ukraine war and COVID distortions has not led to expectations becoming de-anchored. In addition unemployment rates have generally moved up somewhat and so pressure on wages is easing. A soft landing therefore seems in prospect. There are risks on both sides. If policy is not eased sufficiently an unpleasant cycle of higher unemployment causing a deterioration in consumer sentiment could cause a deeper downturn. On the other hand loosening policy too early could boost the economy at a time when earning power is rising and inflation remains above target.

- The good news is that the economic background appears solid. Both consumers and businesses seem not to be stretched. Interest rates are also way higher than they had been. Thus even if there is a more severe downturn than expected it should prove to be shallow given the ability of interest rates to fall with no barriers impacting their ability to be effective. From our perspective, therefore, there is more of an incentive for central bankers to be patient than to panic. We therefore expect the decline in rates to be gradual.

- In the longer run we still expect rates to end up at lower levels in some jurisdictions than current forward rates suggest. For example the five year forward rate in the UK is currently around four and one quarter per cent. Since we don’t think the economic background has changed so much since pre-COVID, albeit there have been some substantive changes, we think the real interest rate is too high. The observation is generally true of the higher yielding currencies. We appear to have tested the highs in interest rates (just above five per cent) but have yet to see the conditions where we get to see the lows/neutral. At the moment we think it quite possible we will have a soft landing and only get to recognise where the neutral rate will be but there is a very real risk that we will experience what rate is need to provide stimulus. Nonetheless our central case is that rates will come down more than expected but do so slowly.

- 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 decreased 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 USD will retain its strength, the UK has high interest rates and a likely fiscal boost so will likely be firm for some time although in the long run it is vulnerable due to a fundamentally weak economic background, the EUR has lower rates and although somewhat firmer economic conditions may sustain it 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, it 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.

2. Portfolio Positioning

- Duration

  Although the economy is slowing down, we don't believe it is weak enough to warrant four rate cuts this year, including the 50bp rate cut that the market is factoring in. Therefore, we believe it is likely that market volatility will increase with future employment and inflation data releases.

  In addition, we speculate that many investors are suffering losses due to the unwinding of broad carry trades, which involve selling currencies with low interest rates and buying currencies with high interest rates, as the timing of the Bank of Japan's interest rate hike coincides with the deterioration of US economic indicators.

  Therefore, it is highly likely that there will be situations in which the market moves in a manner that is contrary to the macro-economy.

  Although the US 10-year interest rate will continue to range between 3.8% and -4.7%, we will assume the possibility of a range break due to the elimination of the above-mentioned loss positions and the worsening of geopolitical risks. Accordingly, we will dynamically manage duration with a focus on longer duration.

- Currencies:

  Since currency-bond allocation may lose correlation between currencies, we intend to flexibly allocate bonds and currencies from a portfolio that maximizes carry by utilizing correlations, while taking into account market positions.

  Considering the possibility of a carry position being rolled back, we plan to flexibly adjust our overweight positions in Oceanian currencies versus the euro and underweight the Chinese yuan versus the US Dollar.

  We will continue with our Poland overweight. We intend to increase our holdings of high quality quasi-sovereign bonds

- 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.

Important Information

Any reference to past performance should not be taken as a guide to future performance. The value of investments may go down as well as up.

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