MUFG Asset Management

Global Fixed Income Monthly

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HEAD OF INVESTMENT

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1. Monthly Macro View

- The economic background was settling down into the likelihood of a soft landing scenario with 2025 allowing us to explore where neutral rates were. The US economy looked a bit strong but the numbers were gradually settling down; the data beneath the headline GDP data appeared increasingly consistent with the inflation target. In Europe the numbers were looking weaker, but the background on employment and savings implied underlying strength in the consumer sector which should help underpin the continued recovery. Inflation had come down and services remained rather too persistently high but expectations remained well-anchored, some of the strength there was residual and there appeared to be reasons to expect continued downward pressure over time. The debate over interest rates was rather narrow.

- Politics has interrupted this narrative, both in the short and to an extent longer term. In the UK a Labour government has pushed up government spending to an extent that whilst remaining in the realms of reasonable, is nonetheless aggressive. It is not expected to solve the problems identified and therefore runs the risk of further budgets that break away from what many would regard as fiscally prudent. In the United States a person several very senior military figures, hardly known for being left-leaning liberals, warned against given their worries about his far right views. In the still far from complete EU the nationalist far right increasingly has a voice.

- How does politics interrupt this? The narrative that we were used to: governments that were centre left or centre right following broadly similar policies on the basis we had a good idea of what maximises growth and social cohesion is faltering. Certain sets of society feel disenfranchised and successfully vote for populist policies which lead to sub-optimal economic outcomes. Given the headwinds facing economies: low productivity, ageing populations, climate change and the need for higher defence spending, it seems likely that the pressures causing this destabilising political background will persist. As an example of the potential issues down the road, Donald Trump in the past has expressed a strong view that he should have a say in the setting of interest rates. This would be difficult to achieve in the US, but the wish and intention is clearly a challenge to the consensus that has achieved great success in controlling inflation.

- We spoke before about government debt levels and markets seem to have finally started to focus on this. We have described the long term pressures above and the starting point is unfortunately from a high debt base. The EU is softening previous strictures whilst still retaining control of the issue. The UK finds public services stretched but tax levels as a percentage of GDP at the highest level since the 1940s and not helped by currently running a deficit. The United States has an economy at full capacity and a deficit running at six per cent of GDP. The UK has and the US will boost fiscal policy at a time when the central bank is trying to reduce inflation and the economy is at full capacity: it is not the best of policies. In the long run many debt trajectories are not sustainable. If they are controlled it will be very positive for rates. If not things will become very uncomfortable. At the moment populations appear to have little appetite for stepping back.

- The good news is that the private sector economic background appears solid even if productivity is weak. 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. Whilst still expecting rates to decline we think that decline will take longer to play out.

- In the longer run it will be the underlying economic factors that will determine where rates settle unless populism causes far more serious issues than we currently expect (e.g. changing the mandates of central banks). In that respect we still think bond yields in some jurisdictions represent good value: productivity is low, demographics point to downward pressure on rates and inflation expectations are well anchored. In the 1960s productivity and population growth was significantly higher than today with inflation expectations constrained: real ten year rates were at 2.4%. Assuming inflation settles at 2% then current ten year rates in the US are at 4.4% and the UK 4.4%. Despite the short term risks this appears to be decent value. However, given the upside growth and inflation risks from tariffs and a slight fiscal boost it may well take time for this value to be realised.

- We think spread product remains decent plodding 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 in strongly. Financials in the US are good value versus Industrials given the currently unusual spread differential between them.

- Currencies: in the main neutral. The US and UK are providing fiscal boosts at a time of full capacity. The US may well also impose tariffs. This should result in USD and GBP strength, but much of this appears discounted. China is struggling but stimulus actions are likely positive in the short run, albeit the problems appear deeply structural. The Euro economy is failing to grow as expected and faces difficult political issues.

2. Portfolio Positioning

- Interest rates
  Although the economy is slowing down, the view that the US economy is continuing to perform relatively strongly remains unchanged. In the previous month, the Fed's dovish tone strengthened, and we expected the dollar to weaken and emerging market currencies to strengthen, with risk sentiment improving, but we think that this was pushed back by the October employment data and expectations of Trump's re-election. We think that this rise in interest rates is more a result of speculation by speculators over concerns about inflation and worsening public finances due to Trump's policies, rather than reflecting the macro economy. For this reason, we are also considering the possibility of interest rates breaking out of the 4.5% range. In addition, as interest rates rise, the interest rates on various loans will also rise, so expectations for macroeconomic data will decline. We assume that interest rates will also peak at the same time as stock prices reach their peak. For this reason, we think that interest rates will return to around 4% as volatility declines. However, for the time being, we expect US 10-year interest rates to be around 4.0-4.7%. The interest rate strategy is to take moderate positions with a long-term focus.

- Currencies
  The currency strategy is to increase carry while also keeping an eye on Trump's foreign policy and geopolitical trends, and to respond flexibly with a focus on US OW/China UW, Euro UW/Poland, Norway, and Australian OW.

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