MUFG Asset Management

Global Fixed Income Monthly

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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 calming down. 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 remained too high but the levels were more comfortable and the dynamics positive. 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 and in France are severely hindering efforts at a mild (frankly too mild) fiscal consolidation.

- 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. Indeed these pressures far from not going away in the longer term are only going to intensify.

- 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. At the moment populations appear to have little appetite for stepping back. This is not to say it won’t change. The fight against inflation in the 1980s required heavy recessions and the public voted for it. At the moment, though, it is not a public priority.

- 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 decent 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 and the UK are at 4.3%. 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. Long ends, however, are likely to be hindered by the fiscal risks.

- 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

- Rates
  The impact of Trump's policies has the potential to cause a valuation adjustment in the stock market, which has been rising on expectations of future policy but could lead to an expansion of spread and a fall in interest rates. There are many people in the market who point to the impact of the tariff war, but there is potential that the impact of the dismissal of bureaucrats promoted by Trump and Elon Musk could have a greater impact on the US market.

  We expect US interest rates to be around 3.6-4.3%, with 4% as the core case

- Duration
  We think that the probability of a decline in interest rates is higher than that of an increase, because inflation is on a downward trend and there is a possibility of a correction due to high stock valuations, so we will manage duration with a longer focus.
  In addition, we expect that geopolitical risks will ease, so we will continue to hold overweigh positions in Poland, Spain and Norway, which are advantageous in such an environment, and overweight US versus China.

- Currencies
  The euro has some potential weaknesses, such as the impact of the Chinese economy on major exporters like Germany and the rightward shift in major countries triggered by the end of the war in Ukraine. However, while major countries in Europe are shifting to the right, countries such as Poland, Spain and Norway are not shifting this way, and it is predicted that they will take a relatively dominant position within Europe, so countries like this are OW against the UW of the euro. The US is OW because it has a relatively strong economy due to the remaining asset effect. With regard to the UK, structural inflation is stronger than in the rest of Europe, so interest rates have to be set high, but the economy is generally weak, so we expect it to slow down at some point. For this reason, we are taking a longer duration position without taking a large currency position in UK.

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