MUFG Asset Management

Global Fixed Income Monthly

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HEAD OF INVESTMENT

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Mitsubishi UFJ Asset Management (UK) Ltd.
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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.

- The headwinds facing economies and for fiscal outcomes are daunting. Ageing populations require more resource from a decreasing source of those paying for it (workers), greater defence spending means devoting large chunks of GDP to something that is (hopefully) never used, climate change means expensively replacing one input for another with no increase in output. At the same time productivity growth remains low.

- 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. It is unsettling that difficult times appear to result in irrational responses.

- Fiscal spend has been an easy choice: governments face demands to spend but get voted out if they raise taxes. Answer: borrow. However, we are starting to see the end of that process. Markets are becoming concerned, some Republicans are remembering their roots, the UK has shot its bolt and the EU does have fiscal rules. However, we are just at the beginning of the end and given the slow burn on fiscal outcomes it is likely the concerns are more likely to keep yields elevated for a while until there is a consensus that consolidation is required. We should hope there are no more economic crises before that happens. At some stage the public, as they did with inflation in the 1990s, should get behind consolidation. The populists are only likely to delay it and make the resolution worse.

- 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 and Duration

Against the backdrop of recent economic data, Trump policies, and uncertainty over the neutral interest rate, interest rates have risen above the expected range. However, given current stock valuations (S&P PER of around 24x, 1-year forward EPS forecasts of over 10%) and interest rate levels, there is room for both interest rates and stocks to adjust. Therefore, we will continue with our long duration bias in the US and UK.

In terms of non-government bond strategies, we will reduce our weighting in preparation for a correction in the US stock market, and maintain a structure that can take on risk when credit spreads widen by holding high-quality paper.

- Currencies

We continue to focus on changes in money flows due to geopolitical risks, and the ripple effects of monetary policy on the real economy

The US labour market is moving from tightness to normalization, yet is continuing to be firm. Reflecting the strong US economy, interest rates are rising, the dollar is strengthening and stock prices are rising. However, there is a risk of overheating stock prices - accordingly we are mindful of the possibility of a correction and wary of the impact on currencies so envisage a volatile in the euro-dollar rate.

We expect the conflicts in Ukraine and the Middle East to subside following the inauguration of President-elect Trump. We will maintain the same level of exposure to dollar-denominated and euro-denominated currencies,and we continue to short the euro and Chinese yuan against the US dollar, Polish zloty and Norwegian krone.

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