MUFG Asset Management

Global Fixed Income Monthly

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Mitsubishi UFJ Asset Management (UK) Ltd.
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1. Monthly Macro View

- What is going on in America currently is clearly the dominant factor for markets. There is a debate about whether the US Administration has a coherent philosophy and agenda (for example Gillian Tett) or whether it just reflects the chaotic and poorly formulated views of the President (Paul Krugman). Either way the effects are profound in both the short and long terms.

- The major recent development is the introduction of tariffs. Very few people see the tariffs as making economic sense, either in principle or in the formula used (even that was incorrectly applied since retail prices rather than producer prices were used). Financial markets see them as economically damaging. Will they stay as is, get negotiated, will Trump lose support? It is an absurd situation.

- Other areas have not had such a large market impact but are very worrying for the long-term outlook. The rule of law is being threatened: lawyers losing government contracts because of their legal work in areas trump disapproves of verbal attacks on judges, the Vice President saying the President can ignore the Supreme Court. Free speech under attack: Universities threatened allegedly for anti-semitism and diversity programmes. Efforts to avoid due process: people can be abducted by the State without any protection. Alliances formed over decades are being casually abandoned in a brutal fashion. There has been talk of Canada and Greenland being forcibly made part of the US Congress (where spending authority lies) has been disregarded.

- What are market impacts? Given the chaos and possible abrupt changes to policy it is difficult to be certain. The growth impact of tariffs will push interest rates lower; the inflation impact will push them higher. Given higher inflation the Fed will need to assess the balance between the two but assuming inflation expectations remain well anchored they are more likely to respond to growth than inflation. So lower short-term rates. In the longer term, less trade means less competition which pushes up price pressures, productivity should be lower due to misallocation of resources, interest rates should be pushed higher as reallocation of sunk costs comes through. Therefore, longer rates will benefit from lower short rates in the short run but will be higher than they would otherwise have been in the long run.

- For other countries the tariffs will have a negative impact on growth (directly and because of the global and US specific slowdowns) but less of a hit on inflation than they will on the US so lower bond yields and more so than in the US. The longer-term pressures will, however, also have an impact but again less so than the US given that not all of their trade attracts tariffs.

- The crazy stuff. Trump showed in his previous term the ability to keep abruptly altering direction which made investing based on policy very difficult. He may well do the same again. Also in his previous term he heavily criticised the Fed and stated he should have a say in the setting of interest rates. Given his increasingly autocratic actions there remains some risk of him taking up this particular cudgel again: markets would not be keen on this.

- Regarding currencies the dollar should strengthen given the relative growth hits, but it was rather expensive to begin with and much was based on US exceptionalism as implied by the S&P500 relative pricing. This has been crushed. We are therefore inclined toward neutrality on currency positions currently

- Spread has obviously moved out. This has nothing to do with economic cycles or poor balance sheets and everything to do with the strange actions of President Trump who having inherited a solid economy seems bent on ruining it. Spreads have moved up to the median so if a recession does occur, they may move out further. However, balance sheets are starting out in an unusually strong position relative to usual downturns which at times are often due to stretched financial conditions. In addition, the Fed has plenty of room to cut rates and given markets are forward looking on the assumption inflation doesn't hold them up too much markets may well anticipate the end well beforehand. We are currently maintaining our small long with a view to increasing exposure.

2. Portfolio Positioning

- Rates and Duration
  We judged that the interest rate level of around 4% and the high valuation of stocks, which have remained unchanged from the previous month, are likely to be adjusted in the face of a full-scale tariff war. We feel that the impact of tariff policy on the market is similar to the situation with Trump's tariffs in 2018. Considering the tariffs on automobiles and reciprocal tariffs, the situation is worse than last time. Therefore, we have increased our allocation to longer-dated bonds (some in the UK) centring on the US, and we have also increased our allocation to Poland, Sweden and Norway, which are key countries in the context of the expansion of military spending in Europe. We have reduced the non-government bond weighting from 16% to around 12%, and we have continued to reduce credit risk from the previous month.

  As in the previous month, we expect a correction in US stocks and have set a lower limit of around 4,900, which is just before we start factoring in a recession. As we think it is too early to factor in a recession, we are taking a longer-term approach, focusing on the US, with a target of around 3.6% for the 10-year US Treasury yield, which factored in the previous recession.

  Although US interest rates fell in anticipation of an economic downturn due to the Trump administration's tariff policy, we expect to see volatile movements, particularly in the long-term and super-long-term zones, due to concerns about a resurgence of inflation and a shift away from US government bonds. Although we will manage the overall duration with a slight focus on longer durations, we will keep risk levels low and adjust risk by monitoring investor position trends and the impact of tariff policy on the economy.

- Currencies

  Although some investors reacted to the sense of overvaluation of US stocks and the uncertainty surrounding the Trump administration's tariff policy by factoring in a recession and reacting with lower stock prices, weaker dollar and lower interest rates, there is still a high level of uncertainty surrounding the impact of the tariff policy, and we expect to see continued volatility in currencies in general, including unwinding of positions.

  While maintaining a similar weighting for dollar-denominated and euro-denominated currencies, we will manage positions with a focus on the euro against the Swedish, Norwegian and Polish currencies and the US dollar against the Chinese currency, taking into account international developments, but we will adjust the weightings as appropriate in light of risk sentiment.

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