MUFG Asset Management

Global Fixed Income Monthly

GARY HUTCHINGS
HEAD OF INVESTMENT

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1. Monthly Macro View

- The economic background continues to show a firm US economy but other areas being more subdued. Inflation has come down and is now largely within striking distance of target. That would appear to imply considerable similarities, but outcomes are somewhat different in the detail. The EU economy has looked weak and the expected pick-up from real wages has failed to follow through. There is no panic but the outlook easily allows interest rate cuts given the wage outlook and economic outlook are both soft. The UK GDP outlook is weak but wages and inflation have remained sticky. The situation hasn't been helped by a fiscal boost from the government. There is much talk of stagflation. The US economy is growing at or a little above trend, but wages are not troubling although inflation remains a bit high with little impetus for it to subside. Canada has seen unemployment ratchet up and China remains in the doldrums.

- For us higher yielding markets remain relatively and absolutely attractive, The stagflation fears in the UK may well be realized in the UK during 2025 and the Bank of England clearly has a difficult path to follow. However, given they will stick to their mandate and given the government has no more fiscal room in the longer run UK rates look incompatible at levels not just about EU rates (where we would argue the economy is quite similar) but at or above US rates (which is clearly fundamentally far stronger). The US is less obvious, but we think bonds versus equities are attractive and also think US yields at the intermediate to longer end will either stay where they are or will fall. Therefore moderate long duration positions are justified.

- One problem with this simple analysis is politics. The obvious example currently is tariffs. The imposing and then delay makes predicting markets awkward. This is more so when the reasons given for the actions against Mexico and Canada make no sense at all and the reasons given for the delays make no sense either. Yet clearly there is also something deeper going on. The rise of the far right in the EU, Reform in the UK and the remarkable re-election of Trump reveals a very troubled electorate who appear to want radical action to be taken. Sensible commentators in the US are talking about interpreting Trump actions as an attempt to enforce a dictatorship. As investors it is not our place to be concerned about this except as to how it might affect our holdings. For the moment the administration does seem to pay attention to the large fiscal deficit, a number of comments have been made about sensitivity to ten year rates and it is pretty clear no one wants to damage the stock market. So thus far we can continue to focus on usual economic indicators. However, the political climate is making things very difficult given the risks of non-centrist or populist actions.

- 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 real rates in the US and the UK are at 2.5%. 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
  The IT-related companies that are driving the US stock market are seeing their capital expenditure balloon due to increased costs from the battle for NVIDIA's high-performance GPUs. For this reason, the emergence of DeepSeek, a company that uses open code rather than high-performance GPUs, could be a factor in the depreciation of future profitability. In order to maintain share price levels, lower interest rates will be needed, and if interest rates remain high, a new story will be needed to explain expected rising corporate earnings. Considering all this, there is an advantage to being long in duration.

- Currencies
  While broadly neutral, we are watching currencies that are likely to be negatively affected by the Trump administration's retreat from geopolitical risk and tariff wars. On the flip side, we are also focusing on countries that are likely to benefit from tariffs and their secondary impacts. Accordingly, we are long the US, Poland, Norway, Israel and Malaysia and short China and euro.

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