MUFG Asset Management

Global Fixed Income Monthly

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HEAD OF INVESTMENT

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A member of MUFG, a global financial group

1. Monthly Macro View

- Inflation data has come down into a better zone but it remains too high. Whether it falls happily to target and stays there or lingers over time above and requires interest rates to be restrictive for longer is a question which will be determined by how resilient economies are.

- On the whole economies in terms of growth appear to have varied quite a bit, but looking at the employment data the theme is largely one implying growth at trend. Has trend growth, bar the US, changed so much or is there labour hoarding and remaining supply side constraints? On the whole we think the fall in inflation and subsequent rise in real incomes should boost consumption but relaxing supply constraints should ease enabling inflation to not be a persistent problem. The balance though is delicate and makes predicting the timing of interest rate cuts problematic. For the moment we are somewhat agnostic in this area.

- Where we have more conviction is where rates will ultimately end up. Whilst we recognize that higher government deficits likely require a higher real rate and that AI provides the prospect for higher productivity nonetheless, comparing with previous periods, it seems likely to us that a real rate of between one and a half and two per cent for ten year bonds is a reasonable range given the backdrop. This is higher than the rate since 2018, but lower than previous periods where inflation was more entrenched, productivity higher and demographics significantly more favourable. This makes bonds somewhat attractive at current levels from a value perspective.

- For the moment, though, we have the prospect of better growth data, inflation numbers that are not quite where Central Banks want them and tight labour markets. Monetary policy needs to do all the heavy lifting given government indifference to fiscal tightening. Bonds are therefore likely to range trade whilst tight (but not aggressively tight) monetary policy interplays with a moderately positive economic backdrop. Economic data has led to higher fixed income volatility than is typical due to this dichotomy and this is likely to continue. Ultimately we think rates will come down, albeit not in a dramatic fashion. We are therefore positioned at longer ends to take advantage of the decent value offered but positions are not aggressive.

- We think spread product remains decent if not outstanding 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 strongly. Financials are good value versus Industrials given the currently unusual spread differential between them.

- Currencies: like fixed income currencies will be very sensitive to any signs of continued economic strength or any sign monetary policy is turning things around. Given the resilience of the US economy it would appear the USD will retain its strength. The UK has high interest rates and a likely fiscal boost so will likely be firm for some time although in the long run it is vulnerable due to a fundamentally weak economic background. The EUR has lower rates and although somewhat firmer economic conditions may sustain it the interest rate differential should favour returns from higher yielding currencies. JPY will struggle given a relatively weak economy, the current need to keep rates low to anchor inflation, large interest rate differentials and poor productivity. However, it has fallen a long way and data surprises could lead to sharp reversals.

2. Portfolio Positioning

- Duration
  We are slightly long duration. We are more positive higher yielding currencies meaning we are relatively negative on the EU and Japan. The positioning is based on long term value, not short term economic dynamics. Most work seems to imply the dynamics causing secular stagnation have not shifted much so real rates are likely to settle at a low level. Nonetheless the possibility of AI shifting productivity is gaining ground, the turnaround in geopolitics is notable and the high level of government debt is also an issue. The AI impact, however is likely to be seen further down the road.

  Although we think rates will settle higher than pre-Covid levels we think that they will not remain as high as current levels. In the short run inflation has shifted from external to core internal led as employment levels have remained very high with some possibility that falling inflation will bolster personal consumption going forward. If the market sells off on the back of this we would be inclined to increase duration.

- Currencies:
  Our currency positions are based on:
  1. Current profitability
  2. Future profitability based on each country's macroeconomic disparities and their forecasts
  3. Forecasts of changes in money flows based on geopolitics and international politics.
     From that perspective, we build a portfolio by underweighting EUR and CNY, and overweighting USD, NZD, PLN, and MXN, keeping in mind the correlation between currencies in normal times. Control those weights, such as during risk-off.

- Spread:
  Long and again on value considerations. Not looking for substantial spread compression, but for carry to prove positive. Both consumers and corporates have strong balance sheets so this should limit downside even in an adverse economic situation. Equally we think a boom requiring much firmer monetary action is also a remote likelihood. The latter has been rendered less likely given tamer inflation.

  Nonetheless we are underweight cyclicals. We are also long Financials versus Industrials given the robust balance sheets of major banks and the current wide spreads between the two sectors.
