

- Over the past fortnight, we have taken and executed the decision to reposition the CG Dollar Fund and the TIPS portfolios of the CG multi-asset funds and CG Real Return Fund.
- We have reduced the TIPS duration from 8 years to 4.5 years across all relevant CG funds. This is against a TIPS index duration of approximately 7 years.
- The central rationale for this change is that our outlook for the US economy is increasingly one of stagflation – slower growth, more persistent inflation, and steeper yield curves – rather than outright recession, falling prices, and a flatter yield curve.
- Several factors inform this view:
 - Inflation in the US has been very persistent. PCE inflation has now been above the Fed's target since mid-2021. This is in line with the IMF's findings that historically, the effects of inflation shocks persist for a long time.
 - US politicians and policymakers are showing greater tolerance for above-target inflation than was the case earlier in the cycle. Some of the reason for this is likely political: the Trump Administration has been very clear in its preference for lower interest rates. Some of this is a function of risk management in central banking: the risks to the Fed's dual mandate are more balanced when inflation is at 3% and unemployment is (slowly) rising. But either way, the facts are: inflation is above target and the US economy is growing at above its trend rate, and yet despite this, the Fed is cutting short rates.
 - Meanwhile, the fiscal position continues to deteriorate. The fiscal deficit, 6% this year, is set to widen with the renewal of Trump tax cuts and is forecast to be closer to 6.5% over the next two years. Government debt well exceeds 100% of GDP on both nominal and market value measures.
 - Relatedly, the US Treasury's Borrowing Advisory Committee (TBAC) has warned of waning price-insensitive demand for long-dated US Treasuries. This has become a more central feature under the Trump Administration's funding plans, where, despite initial indications to the contrary, Treasury Secretary Scott Bessent has indicated that he will maintain the current coupon issuance profile, but will materially increase bill issuance. This implies a shortening weighted average maturity of US government debt over time, and perhaps pragmatic acknowledgement of the issues facing longer-dated US bonds.
 - There are also more immediate issues for the US economy and the Trump administration. One of these is that the US Supreme Court is soon to opine on the legality of reciprocal and fentanyl tariffs. Commentary suggests a meaningful chance that the Supreme Court will determine that the tariffs are unlawful. This is now beginning to seep into market sentiment, particularly towards longer-dated bonds.
- US yield curves have steepened materially, alongside those of other developed government markets. Our view is that, despite central banks' continued efforts to cut short rates, markets' focus has irretrievably turned towards features of confidence in government that dominate the long-term segment of the bond market: fiscal sustainability and the debt burden, and, relatedly, the outlook for inflation and growth. These features all suggest that steep yield curves are likely here to stay, with risk of further steepening.
- We have for some time argued that the only politically tenable way out of the growing pile of government debt is through financial repression, which requires a period of negative real interest rates. This would realistically be brought on by one of two scenarios: economic recession, where the central bank intervenes to stimulate the economy; or a bond market crisis; where the central bank intervenes as a price-insensitive buyer. Our view is that the probability of the first of these scenarios has reduced and the probability of the second has increased. In a bond market crisis, long-dated bonds would likely face large capital losses before negative interest rates were reached. Because of this, the risk-reward balance favours a shorter duration, to protect our clients from larger capital losses on longer-dated bonds in the intervening period.
- This is in line with our outlook and positioning in the UK, where our funds are positioned with a 6-year duration vs. index duration of 14.5 years. You will recall that this is a consequence of our concerns for fiscal sustainability in the UK, the reality that the UK is a relatively small issuer in global government bond markets, and the reducing role of defined benefit pension funds in this market. However, with a 10-year CPI-adjusted real yield of c. 1.9% vs a trend growth rate of c. 1.3%, the UK appears to be the better value market, which informs our decision to hold slightly longer, albeit constrained, duration in the UK. In the US, the 10-year TIPS yield, also 1.9%, effectively just buys the trend growth rate of the US economy.

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