April 2015

There Will Be Growth In The Spring

The recent rout in global bond markets is reminiscent of May 2013, when the then Federal Reserve Chairman Ben Bernanke implied rate hikes would come sooner than markets had anticipated as jobs, growth and inflation returned to the US economy. Global bond yields rose approximately 1% over the ensuing month, equity markets fell close to 10%, and virtually no asset delivered a positive return. The markets now refer to this period as the 'taper tantrum'.

The current 'return to growth' message reminds us of Chauncey Gardiner, the gardener in the movie *Being There*, who is mistaken for an economic adviser and while referring to gardening and the four seasons, tells the President that "there will be growth in the spring." This is misinterpreted by the president's advisers as economic growth soon returning.

We see the confusion of Chauncey Gardiner's message repeated today in the misinterpretation of central banker statements. Global economic growth has been in the depths of winter for the past seven years and the green shoots of spring remain further in the future than markets currently anticipate.

Therefore, it wasn't surprising that the two years that followed this 'taper tantrum' event have revealed a continuing weak global economy best characterised by low growth, low inflation, falling commodity prices, and continuing massive provision of central bank liquidity through low rates and quantitative easing.

Until mid-April, global investors should have been fairly pleased with their returns. Equity markets continued their rally toward record highs and bond yields found new record lows. Australian sovereign bonds returned 5.4% YTD[1] through April 15th, while US Treasuries returned 3.3%[2]. Australian 10-year sovereign yields reached a low of 2.28%, US 10-year Treasuries 1.89% and 10-year German bunds 0.10%. Negative bond yields were the story of much of Europe and the Swiss even managed to issue a 10-year bond with negative yields.

However, since mid-April global bond markets reversed course and have now lost almost $500 billion in market value.

Australian markets experienced their own Chauncey Gardiner moment when they misinterpreted the RBA's May 6th announcement as being the final in its series of rate cuts.

Over the past 30 days, 10-year Australian sovereign bond yields have risen 0.70% to almost 3.00%, US 10-year Treasury yields rose 0.35% reaching 2.25%, and 10-year German bund yields have reached 0.67%[3]. There will be growth in the spring?

What in the global economy has changed in such a short period?

In our view, not much. Markets continue to push back their expectations of when Federal Reserve rate hikes will occur, global growth remains fairly weak, the European Central Bank's (ECB) QE programme has just begun, and world economies still can't tolerate higher rates without risking the anaemic growth earned so far.

Explanation for the violent sell off includes expectation that the ECB could end its QE programme earlier than anticipated. After all, Eurozone inflation wasn't negative in April, rising to 0% from -0.1% in March! There will be growth in the spring[4]! Of course this ignores unemployment at a steady 11.3% and the probability of 'Grexit' increasing by the hour.

Global inflationary risks were another excuse, particularly as oil prices increased from $48 to nearly $70/barrel. Whilst we believe predicting short-term oil price moves is just as difficult as predicting short-term yield moves, a secular decline in oil prices seems inevitable as the rapid growth in new technologies acts to both increase supply and decrease demand. This, combined with a continuing Asian slowdown would place a cap on oil prices for the longer-term. And yet another excuse centred on too many long bond buyers looking to exit their positions, particularly as rates hit record lows and negative levels in Europe.

Rising rates are inevitable – but not this early!

Kapstream's view

Whilst we have strong reservations over the economic rationale for such a violent sell-off in global bond markets, we are reminded of a key investment lesson – *don't fight the market*.

Trying to position portfolios to exploit volatile changes in rates is a difficult game – no one will consistently make money trading rates in today's environment. Instead, we remain

[1] As measured by the 'on the run' Australian 10Y bond on Bloomberg
[2] As measured by the Fair Market Total Return for the US 10Y bond on Bloomberg

[3] It is worth noting that those same Australian and U.S. 10Y bonds would have returned -5.7% and -3.0% respectively from mid-April to mid-May (a 30 day span!). German 10Y bonds suffered a similar fate returning -5.5% over that same period.
[4] Of 2020!

focused on delivering a fund with low volatility and have acted to reduce fund risk as recent volatility has increased. The mantra we have diligently followed over the past eight years remains equally valid (if not more so) today – “to manage risks first, returns second”. We cut our portfolios’ interest rate duration to 0.85 years, raised our ‘liquidity bucket’ of cash and government-related securities to over 25%, and sold our more volatile holdings.

But what about the future?

We believe rate hikes, particularly in the US, are further in the future than markets expect – a belief we have maintained for some time now. We expect the Federal Reserve to remain on hold for the remainder of 2015. Wage inflation – in our view the key precursor to general overall inflation and eventual Federal Reserve rate hikes – remains well contained, with average hourly earnings up only about 2.2%, i.e. about the average of the previous 5 years. Additionally, the Federal Reserve’s preferred measure of inflation, the PCE deflator, is only up an annualised 1.4%, well below the 2% target. While an eventual Federal Reserve rate increase will signal a vote of confidence for continuing growth in the US economy, it is an important that policy missteps be avoided so as to not impact the tenuous global economic landscape.

In Australia, we expect the Reserve Bank now to hold rates at 2.0%. However, the economy will get virtually no fiscal help given Treasurer Hockey’s plan to try to bring the budget back to surplus. This will leave the Reserve Bank of Australia (RBA) monetary policy as the economy’s sole supporter. And the RBA will be challenged as continued currency strength and the transition from mining investment to manufacturing/export sectors create further headwinds to growth and employment. The recent sell-off in Australian interest rates leaves bond markets offering compelling value relative to the rest of the developed world; however we will limit our overall exposure given our focus on risk control.

From a growth standpoint, Europe remains the biggest threat to progress. Delusion amongst Greek lawmakers continues to grow, as does our pessimism over their political will and ability to avoid default, despite the ECB’s quantitative easing efforts. However, we believe an eventual Greek default will have little impact on the wider Euro economy.

We expect the ECB’s expanding balance sheet to provide further temporary support for the remainder of 2015, papering over the deteriorating Greek situation. To a lesser extent, the lack of structural reform in other peripheral European economies will remain the key hindrance to growth in the region for the foreseeable future as only moderate progress has been made over the past few years. Despite the recent sell-off we foresee low core European yields to remain over the next few years.

While the US dollar has fallen about 2.5% from its record highs last month, the European slowdown as well as weakening Asian growth will continue to support US dollar strength, especially amidst continuing easy global monetary policy and quantitative easing. We remain bullish on the US dollar, but believe a more cautious approach/position for our long US dollar beliefs is warranted over the coming months.

Overall we believe the theme of low global central bank rates and more liquidity will continue, compelling investors to hold risk assets. We foresee a continuing currency war as global central banks position for export growth amidst deteriorating domestic environments. The US will remain the only developed market not playing the currency game as prior structural and banking reform promote greater growth prospects.

Future financial market returns (specifically from equities & bonds) will predominantly be driven by guidance and statements from central bankers. Central bankers today could arguably borrow a line from *Being There*. When Chauncey was asked about his views on the economy he replies “as long as the roots are not severed, all is well and all will be well in the garden. In a garden growth has its seasons, first comes spring then summer, followed by fall and winter – there will be growth in the spring”.