November 2016

Should I stay or should I go?

Should I stay or should I go now?

If I go, there will be trouble

And if I stay it will be double

So come on and let me know

Should I stay or should I go…

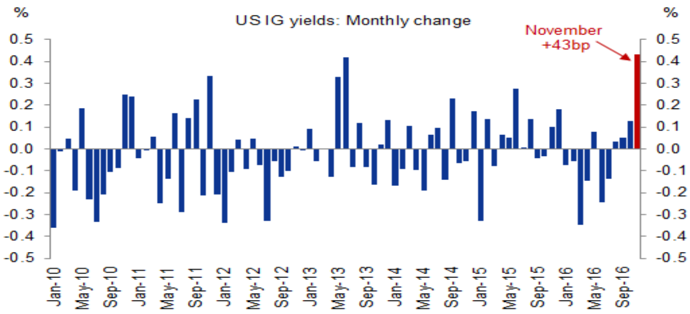
Interest rates, credit quality, liquidity. Who said fixed income portfolio management was hard? Decide on the setting of each exposure 'lever' and bingo, success. Get those right and you're the rock star of the fixed income world. What could possibly be simpler? Well…

We have written about the sensitivity of portfolios to interest rate changes (duration) numerous times before, and those that have followed Kapstream closely will know that we have always held the view that – despite the multi-year value that long duration exposure has delivered to fixed income portfolios – a material bet on the direction of interest rates has generally proven to amongst the lowest information ratio trades a fixed income manager can make.

In an environment where absolute yields from investment grade credit remain subdued (even despite the increases of the past few months), the question of how much duration exposure to take, and where, could not be more important. At the time of writing the duration of the Bloomberg AusBond Composite 0+ Year Index is 4.9 years. Since the start of 2017 the index has returned 2.6%. Simply put, a surprise 0.5% move upwards in interest rates would cause a capital loss that wipes out the entire calendar year return. Granted, an immediate move upwards by the RBA is not anticipated in the short term, but the point is that with bond yields at these low levels they simply don't provide sufficient 'cushioning' to prevent index-based portfolios moving into negative return territory with only a modest non-consensus rate shift.

Most investors in conventional Australian fixed income strategies continue to be exposed to composite portfolios that today yield a little more than 2.5%. While that is an increase from where yields were at midway through the year (about 2.0%) unfortunately with duration of about 5 years they have seen their portfolios devalue by almost 3% in the second half of the year. While admittedly the first half of the year was positive – meaning that they should still see a positive return for the whole year – that doesn't feel like the type of return profile most hope for or need from the 'defensive' part of their portfolio.

The investment grade yield back-up in November was the largest we have seen since the Global Financial Crisis (GFC), larger than even the June 2013 Bernanke fuelled taper tantrum. However, investment grade spreads tightened marginally through the same period, offsetting some of the back-up, and increasing the appeal of investment grade credit to those seeking yield.



Source: BAML, Haver Analytics, Goldman Sachs Global Investment Research

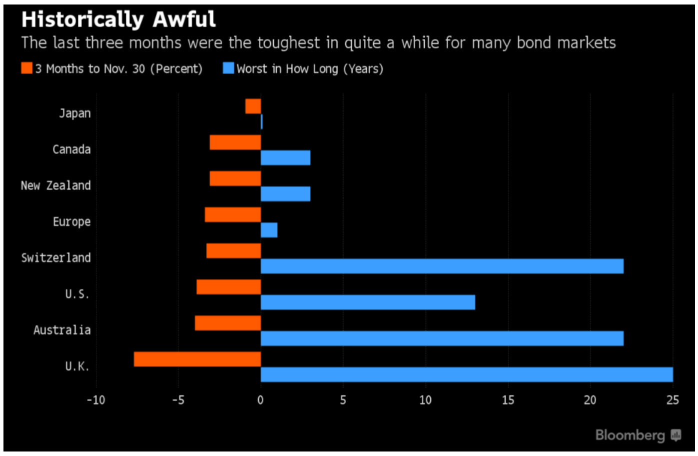
Shorter? Or slaughter…

Managed with capital preservation and an absolute return in mind, Kapstream has only ever permitted itself modest duration exposure (and has hard limits of no more than +2 and no less than -2 years). For the past several years – as rates have fallen more or less continuously – duration in Kapstream portfolios has seldom moved much away from an absolute 1 year level. However, with an apparently sustaining recovery, the Fed more clearly signaling its intent to start lifting rates (and following through on this), we have progressively reduced duration.

Since the surprise Trump election victory, and the arguably bigger surprise of a sustained risk rally in which bond yields have risen/bond prices have fallen, **we have now reduced overall portfolio duration to virtually zero**. In the US where arguably we have passed the inflection point, duration is now marginally short at about -0.1yr. In Australia where it seems unlikely that a move upwards in rates will occur in the short to medium term we remain modestly long at about +0.1yr. Net-net, virtually zero. We expect to hold this position – save any unexpected changes to the macro environment, at least to and through Trump's January 20 inauguration.

Acknowledging the President-elect's pro-growth pro-inflation stance and his 'rather-more-board-than-cabinet' appointments, perhaps as it materializes that managing the affairs of the US from the White House is less straightforward than within the Twittersphere, we may see a dampening of the honeymoon party spirit that has dominated markets since the election.

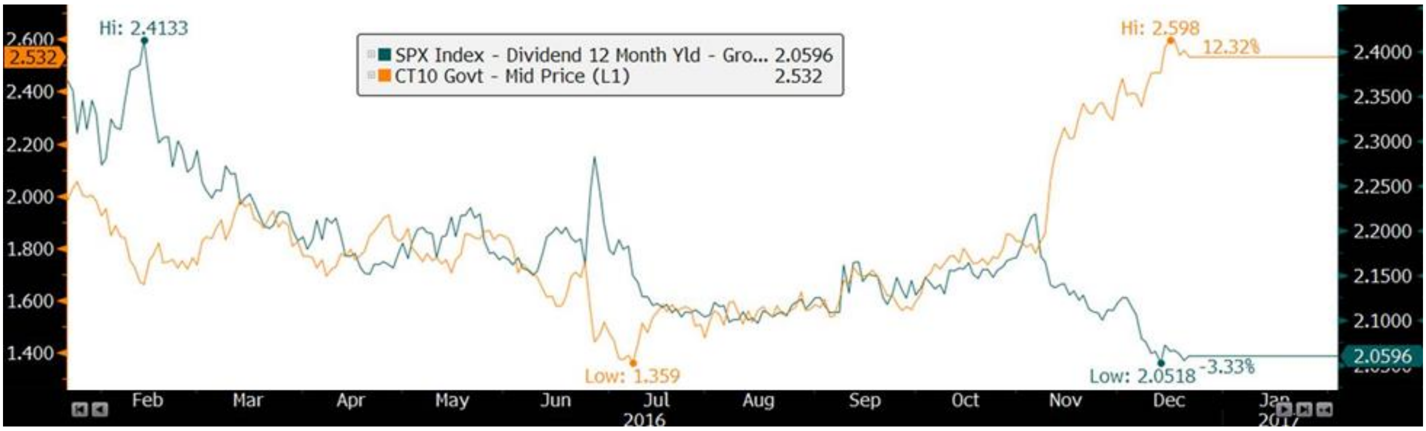
If we reflect on the past three months to November 30th, there have been few developed sovereign bond markets that have been saved as the retreat from record highs seen in July and August accelerated. As the chart on the right indicates, UK government bonds dropped almost 7.4% in three months, the worst slide on record going back to 1992. Australian and Switzerland bonds had their deepest slumps in 22 years. Japanese government bonds were mostly sheltered from the carnage thanks to the Bank of Japan's move to control the yield curve. With such ferocious moves in such a short period of time and the potential for a profound Trump-led ideological policy shift, there is one key question we need to ask ourselves… is the 30-year bond bull market bull finally over, or just another blip as in 1994? Certainly it seems that we have now arrived at the point where reward turns to risk for those with absolute long duration exposures.



Source: Bloomberg

Conclusion

We have little doubt that volatility will remain elevated as we move to and through the transition in US administration late January. A final point of interest is the relationship between bond and equity dividend yields, as shown in the chart below. In the past few weeks yields on (10 year Treasury) bonds have moved above those of equities (using the S&P 500 as a proxy), the first time for a couple of years where the divergence has been this apparent. It remains to be seen if this has the potential to trigger a reversal of the risk rally, and a move back towards bonds. At the very least a Clash appears to be on the horizon…



Source: Bloomberg