FINANCIAL REVIEW

Deficit financing task helped by RBA's hard 'no' to negative rates

Australia's desirably sloped yield curve is making life easier for the fiscal relief effort, says Kapstream's Daniel Siluk.

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4th August 2020

Australia's success funding the record budget deficit will be imperilled if the Reserve Bank deploys negative rates, because they only really work in economies that run current account surpluses.

Last week, the Australian Office of Financial Management ruled off another successful bond sale, raising $15 billion from a new 2051 bond that foreign investors were falling over themselves to bid for.

"It puts a question mark on the government’s ability to keep funding those deficits if the monetary side goes into negative rates," says Daniel Siluk of bond fund manager Kapstream, the boutique now owned by Janus Henderson.

Although their efficacy is still contested by critics, negative rates tend to be a feature of economies running current account surpluses such as Japan and the eurozone. A juicy yield is essential to keep investors interested in buying bonds of sovereign issuers with negative current accounts.

"Despite having a surplus for a short period of time, Australia is typically a deficit economy," Siluk says. The Reserve Bank has "been quite stubborn in terms of stating they don't believe negative rates are the right tool".

The AOFM's raisings have been assisted by the yield advantage Australian bonds command, which in the case of the 2051 bond was 2 percentage points above the comparable German bund of the same maturity. Under negative rates, that advantage would be eroded.

"You need to have some sort of semblance of a positively sloped yield curve," Siluk says. The Reserve Bank's yield curve control (a version of quantitative easing, or QE) has pinned the three-year rate at 0.25 per cent with a little room for variance, enabling a satisfactory steepness at the longer end where the market determines the 10-year rate.

"Every time there's a speaker from the RBA, they keep hammering that point home: QE is there and it's available. QE in Australia lasted just well over a month."

In a career that has taken him to London and Newport Beach, working side-by-side with legendary bond manager Bill Gross, Siluk these days is based in Sydney, not far from where he grew up in the Hills District in a no-nonsense Polish Catholic household centred on education and faith.

"They taught us head down, bum up and work hard. Really, I certainly feel blessed, I guess, just given the support my family gave me," he says. "Their only goal in life was to see their children do better than themselves."

As a student he gravitated to actuarial studies but the reality of studying morbidity tables for the insurance industry led him to consider what else was out there, so he switched over to applied finance.

Upon graduating, he couldn't get the funds management jobs he was interested in, so he ended up at Perpetual's former custodian business learning the building blocks of the asset management industry.

But his biggest stroke of fortune was landing a job at Challenger, which had just signed on Kapstream, founded by Kumar Palghat and Nick Maroutsos. Siluk became employee number four and has been with the firm for 11 years. Janus backed the boutique in 2015, buying out Challenger.

And although Palghat has since retired, he's still known to dial into portfolio manager meetings.

"He's like a father figure to all of us," says Siluk. "It's his baby as well."

The other significance of the Kapstream deal was that it put the boutique in the same orbit as Gross, who moved to Janus after leaving Pimco in dramatic fashion, and is also a former colleague of Palghat's. Gross retired last year.

Working with Gross

Siluk worked in the Newport Beach office, started by Maroutsos, supporting the bond king, which he remembers fondly as part of his three-and-a-half years living in the US.

"You sit in taxis, waiting lounges at airports and you get to meet and talk to a vast array of people, and one thing I did find is your average American was just more likely to have a conversation with a stranger than an Australian is." he says.

"I got really interesting perspectives from taxi drivers that carry guns versus the far left-type person. I had a really great experience in the US."

He and Maroutsos would support Gross' strategy by executing trades and marketing to outside investors.

"Quite frankly, Janus weren't prepared for a Bill Gross, not from an operational or a systems side, and not from a marketing or a distribution side."

Siluk agrees Gross is one of the greatest ever bond traders and macroeconomic thinkers.

"Bill wasn't one at that point in his career to put his arm around your shoulder and say, 'Here, I want to show you something,' but just by sitting on the desk and watching his trading activity, it was eye-opening. I think that was probably the highlight of my career so far, being in the presence of one of the best fixed income investors of our generation."

The global monetary support playing out is essential, Siluk believes, and also recognises that the austerity experiment was a policy error.

"It's something we have to do. If you look at prior crises, where the monetary side of the equation was supporting the economy, the fiscal side was acting against the monetary side.

"The perfect example is the eurozone crisis, reining in spending pretty much at the order of the EU. That didn't work out well for them. If there's one thing we've learned from adverse shocks it's that the monetary and fiscal side need to work together."

Risk posed by US election

The US presidential election, where polling shows Joe Biden leads Donald Trump, is a big risk for markets and global sentiment, but probably more of a short-term risk, he believes.

"You could see a shock in markets but more overwhelming is really COVID-19. Some months post the election it doesn't really matter if Republicans or Democrats are in the seat – if there's a vaccine then stock markets are off to the races again."

And yet, three months in politics is a long time, Siluk suggests. Things can change, but the extent of the silent vote that went undetected by most pollsters in the 2016 election is probably insufficient to close the gap with Biden on the current numbers.

"Trump is behind 8, 10 per cent depending on which polls you look at."

The record high in the gold price last week, unseating the previous high watermark of 2011, is not so much a vote of confidence that inflation will storm back but a consequence of incredibly low real yields, he believes.

"What you're seeing with demand for commodities such as gold is the fact that real yields are negative. Gold is a negative carry asset class by virtue of the cost of storage, yet if you compare it to negative real yields then gold is a good alternative.

"It's not so much the reflation story."

Whether it's interest rate markets or commodity markets, "they're certainly pointing to a period of uncertainty, whereas stocks seem to be a little bit divorced from real economic data".

Stocks are "your ultimate long duration asset".