Insights from the CIO

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JCB

JAMIESON COOTE BONDS

- Riding out the market storm and finding true ‘defend and protect’ assets
- U.S. monetary policy now into ‘restrictive’ territory. Buckle up as U.S. Fed Chair Powell looks set to hold the course
- Credit becomes a major concern for institutional clients as funding rates explode higher
- Global data velocity remains sharply negative
- Australian mortgage rates rise in further ‘out-of-cycle’ rate rises.

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Despite many expert predictions that bond markets would prove a hindrance to portfolios in a rising interest rate environment, as we finish the first quarter of 2018, JCB sees high grade bonds defending and protecting capital inside portfolios, in the face of higher global funding costs. Equity markets have taken a hit in Q1, with Australia’s major equity index returning -5.04% whilst the AU Treasury Index was +1.02%.

To make sense of this from an investor’s perspective who has been reading ‘bondcano’ headlines for the past 12 months, there is a simple explanation as to why high grade bonds have always been and continue to be a cornerstone defensive allocation for portfolios.

- Volatility is rising, making investors demand higher expected returns (i.e. lower equity prices) to compensate for wild daily swings in equity markets.
- In contrast, bond markets tend to perform as they estimate harder economic times.

The financial storm of restrictive policy often sees investors seek the safety and surety of Government guaranteed returns, particularly as bonds have cheapened earlier in the hiking cycle. Similar to the price of a share in a listed company cheapening to reflect expected future earnings/forecasts etc before an actual event/outcome, much of the ‘price action’ in bonds happened prior to the hiking cycle. This is the essential point that is often overlooked by staunch equity investors who have been critical of bonds over the last 12 months.

RIDING OUT THE STORM OF GLOBAL MONETARY TIGHTENING

With the first quarter behind us, investment markets, policy, and in particular human investment behaviour are changing rapidly. The U.S. Federal Reserve (the Fed) has lifted interest rates once again (i.e. lifting the global cost of capital) in the first of three expected hikes of 2018, taking policy from accommodative to restrictive in nature. Restrictive monetary policy has immense implications for all asset classes as the global cost of capital rises. What we have learned from previous cycles is that moving into restrictive policy settings is generally an inflection point of the rate rising cycle where asset owners start to worry about what’s over the next economic hill. With U.S. policy looking as though it will be additionally restrictive going forward and funding rates rising quickly, liquidity can be drained from the financial system which has not ended well in previous cycles.

U.S. MONETARY POLICY NOW INTO ‘RESTRICTIVE’ TERRITORY AND CORPORATE CREDIT FEELING THE STRESS

After completing its sixth rate hike of this cycle, the Fed policy has now entered ‘restrictive’ territory with the upper bound rate of 1.75% being above that of the Fed preferred inflation measure, being the core PCE inflation rate (current reading for February year on year is at 1.60%).

Monetary policy has a significant lag (some 18 months) to fully work through into the real economy. In setting monetary policy, the Fed is trying to estimate where future inflation might be, adjust policy to reflect that prediction, whilst knowing that today’s actions have a significant lagged effect. This is more of an art than science and has been historically prone to error over time. The markets’ expectations remain for additional hiking over the year, which could further drain liquidity from the financial system and tighten financial conditions via higher funding costs.

Whilst the Fed has been following a steady program to lift interest rates, LIBOR rates have shot markedly higher due to Trump's tax package. LIBOR is the rate at which banks lend to each other and is often viewed as a financial stress indicator – with higher interbank lending rates being reflective of market stress. Three month LIBOR rates are now above 2.30%, having risen from a low of 0.23% in 2014. This higher LIBOR rate drives interest rates on more than $350 trillion of debt and derivatives contracts higher at a time when half of the investment-grade corporate bond market in the U.S. is at the weakest possible investment grade rating of BBB. Low credit quality along with significantly higher funding costs is a toxic mix.

CREDIT BECOMES A MAJOR CONCERN FOR INSTITUTIONAL ASSET OWNERS AS FUNDING RATES EXPLODE HIGHER

Bond markets are often over analysed and needlessly over complicated. Essentially there are three major components to a bond market:

1) Duration – **when** you get your money back.
2) Volatility – **how** you get your money back.
3) Credit quality – **if** you get your money back.

Higher funding rates (led by the Fed and LIBOR increases) have given investors concern with regard to the quality or the '**if**' component of credit. Despite a healthy rally over the month of March in Government bond yields, many corporate credit bonds failed to participate at all, with some actually losing value as a re-adjustment of their perceived credit quality was re-priced into such securities.

JCB wrote about the asymmetry of credit in previous months, however, we have been surprised by the speed at which such moves are playing out. In speaking with many institutional asset owners over the last quarter, such re-pricing of credit risk has been a major concern after a decade of accommodative monetary policy. This has given rise to some complacency in credit risk allocations and we understand many institutional investors are now re-assessing that allocation.

Earlier this year credit compensation (credit spreads) hit pre-GFC levels, leaving little room for error moving forward. The quality of many credit contracts in international markets has weakened significantly, with record numbers of covenant lite bond issuance securities coming to market. With weak covenance common place, little historical compensation and now restrictive monetary policy – it is no wonder this shoe is now dropping at this stage of the cycle.

GLOBAL DATA VELOCITY REMAINS SHARPLY NEGATIVE

Global data remained broadly healthy over March, however the velocity of the data continues to decay with G10 economic data surprises now turning negative. The data has declined from a reading as high as +60 in late 2017. Markets are adjusting to the trend in data, not the absolute reading themselves. Whilst some of this decay is seasonal, the sharp rise in funding rates and LIBOR over early 2018 is no doubt having an effect in the real economy. The GFC was the result of lifting the funding burden on the world's biggest ever debt bubble (in the U.S. by 4.25% during 2004 to 2006). In response to the bust of the GFC, the world essentially doubled down on that already record debt burden. Much of this newly minted debt was effected at an essentially zero (and in some instances negative) interest rate policy, which was very cheap to fund at that time.

Fast forward to now, and we are told by Central Bankers that we can raise rates by approximately 3% in the U.S. on 2x the outstanding debt burdens but employment, growth and inflation will remain essentially unchanged. JCB believes that is a highly improbable outcome. Higher funding costs do bite, it is just a matter of when and by how much, and at that point the '**if**' in bond markets becomes incredibly crucial.

AUSTRALIAN MORTGAGE RATES RISE IN 'OUT OF CYCLE' RATE RISES, FURTHER DELAYING ANY RBA MOVE

As we have seen previously, additional U.S. rate hikes are flowing through into Australian mortgage rates via 'out-of-cycle' hikes for domestic borrowers, with the majority of mortgage rates trending higher. Westpac lifted mortgage rates by up to 0.40% for both owner occupiers and investors, and Suncorp Bank announced rate hikes on all its variable rate home loans.

JCB continues to believe that this additional rate pressure is likely to persist as the Fed continues to raise rates, leaving the RBA with little to do over the coming year as the economy experiences a mild tightening of conditions. Such mortgage rate rises (combined with additional funding pressure between banks) is effectively more than a complete 0.25% rate hike for the economy, which continues to experience little inflation velocity and maintains excess capacity in the labour market.

FURTHER INFORMATION

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