Insights from the CIO

APRIL 2018

— 3% U.S. 10 year yields, over hyped but a natural target
— Banking Royal Commission wash up to see credit conditions tighten further, dragging on second half growth
— One by one, RBA rate hike calls are removed
— Australian dollar dives below 75 cents as inflation stays below RBA target
— More rate hikes for the US – the oldest story in finance.

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3% U.S. 10 YEAR YIELDS, OVER HYPED BUT A NATURAL TARGET

The old adage, "when the U.S. sneezes, global markets catch a cold" speaks volumes about the size and influence of the U.S. markets relative to the rest of the world. In the bond space, much attention is accordingly paid to where the U.S. 10 year Government Bond yields are tracking. This marker has a profound influence across the financial world on the cost of borrowing, the accessibility of credit and ultimately economic activity.

During April 2018, U.S. 10 year Government Bond levels breached 3% off the back of perceived inflationary pressures and a hawkish U.S. Federal Reserve (the Fed) which has recently backed U.S. economic growth, healthy enough to withstand higher rates. This coincided with geopolitical headlines and ongoing U.S., Chinese, Russian and Iranian dialogue which heightened financial market volatility. Selected popular media segments zeroed in on the bond move, which according to them, could mean further selling of Government Bonds worldwide. JCB does not believe that such expectations are warranted given a global economy that is already slowing as quickly as funding pressures rise (see our March monthly comments on data velocity). JCB views these outcomes as part of a normal functioning of markets within a broader hiking cycle.

The rise in U.S. yields has naturally brought many other global markets along for the ride. In Australia, for instance, interest rates across the yield curve also rose in sympathy despite the domestic economic fundamentals not justifying such a change. Meanwhile, it is helpful to remember the broader context; rises in 10 year rates drive borrowing costs across the system. Material and sustained moves could potentially harm the real economy by stifling activity, and ultimately bleed through to other assets such as shares and property.

This bond market re-pricing has continued to encourage reflection and alteration amongst domestic investors on the right-sizing of their defensive asset allocations. In what is universally recognised as a quite late-cycle stage, sophisticated investors (such as large superannuation plans and industry funds) have latched onto the theme that interest rate risk and credit risk will likely diverge moving forward. This sentiment makes sense against concerning indicators of weakening credit conditions, which are now routinely emerging.

For example, Bloomberg shone a light on the rising stress amongst companies in the recent survey by the National Association of Credit Management. A highly competitive and seemingly strong economy has forced firms to boost borrowing at low rates to keep pace with competitors. However, the survey results revealed the difficulty in remaining on top of debt as illustrated by creditors' ability to collect money owed by their customers – this tumbled to 46.7 in April from 59.6 in March, putting it at its lowest level since early 2009, the height of the financial crisis.

BANKING ROYAL COMMISSION WASH UP TO SEE CREDIT CONDITIONS TIGHTEN FURTHER, DRAGGING ON SECOND HALF GROWTH

The Hayne Banking Royal Commission has captured widespread attention and has uncovered a number of disturbing behaviours and decisions reeking of greed and fraudulent behaviour (liar loans, cash bonuses for processing fraudulent loans with incentive bonuses for writing additional loan business, shameful and willing deceptions of the financially vulnerable). Changes will occur in coming years through increased regulation and oversight, as well as perhaps criminal penalties for executives. From an economic viewpoint, the depressing lessons will have a deep impact on the lending process in the form of higher hurdles to approve loans, greater scrutiny of prospects and less emphasis on pure sales (i.e. balancing shareholder with client needs).

The net result is likely to be heightened pressure on credit standards and, ultimately, borrowings with effects on lending activity in Australia. The timing economically is not ideal given that conditions have already been tightening in view of global funding rates trending upwards (led by the Fed). The domestic Australian outlook is already looking challenged by a deeply indebted Australian household which is facing the prospect of softer or falling property prices in 2018 and beyond. Where formerly bricks and mortar have steadily been appreciating and therefore represented a key driver of consumption, this condition is likely to lessen, applying additional pressures on households.

ONE BY ONE, RBA RATE HIKE CALLS ARE REMOVED

Conventional public relations wisdom tells us that controversial headlines are more likely to garner attention in the media than not. Thus, for those bond market professionals motivated to secure air time, an easy way to become front-and-centre is to call for RBA rate rises against a fragile and uneven environment (where JCB believes we currently find ourselves). Since late 2017, a number of strategists have called for such moves with little regard for the broader economic picture. Many of these market calls from domestic banks, macro funds and other finance firms have tended to evaporate as more information released underlines the soft economic ground we find ourselves on.

JCB's view, in contrast, has tended to be non-sensationalist; a higher (and growing) cost of global capital would suppress consumers at a time when Australian households are highly interest rate sensitive and enjoy little wages growth to offset such a cost push. Whilst JCB has been vocal in our view of 'RBA on hold' for some time, we are not entirely wedded to that view and will gladly call for rate hikes when we feel they are truly imminent. The major change that could allow for RBA rate hikes would be AUD currency depreciation.

AUSTRALIAN DOLLAR DIVES BELOW 75 CENTS AS INFLATION STAYS BELOW RBA TARGET

Ironically, Australia's continued weak inflation pulse generates its own inflation via currency depreciation. Soft inflation kills any future RBA hiking expectation which removes heat out of the currency due to lower expected interest rates (domestic rates versus the U.S. interest rates). JCB has written previously on the power of interest rate differentials driving foreign currency valuations in the longer term. As short dated U.S. interest rates continue to rise, JCB felt this year the USD would benefit (see our December 2017 monthly update titled '2018 the year of the USD') and AUD currency weakness would prevail. Such weakness opens up possible year-end targets towards 68 cents, which would help generate the missing inflationary impulse in the Australian economy via a rise in tradeables inflation.

Whilst currency movements in the short term are often 'random walk', interest rate differentials have excellent long run predictive abilities and JCB retains the view that the USD should continue to appreciate. A lower AUD is potentially good news for the RBA, however, investors must remember that the RBA is focused on the value of the 'trade weighted' AUD, rather than the USD cross rate alone. From the highs earlier this year, the trade weighted AUD has declined around 5.5%, helped no doubt by the Royal Commission findings.

MORE RATE HIKES FOR THE US – THE OLDEST STORY IN FINANCE

The Fed is projecting six more rate hikes by the end of 2019. This is known and priced in by markets. However, JCB is not alone in worrying that this is potentially a repeat of the oldest story in finance – too many hikes will invert the term structure interest rate curve (short rates will be higher than longer dated rates) and this will trigger a recession. No doubt the Fed will alter their thinking as risk markets decay but, so far, they have shown no interest in backing down. It is important to emphasise that none of this is imminent. The U.S. economy is not yet at risk and the sharemarket would have to undergo a larger correction before the Fed might begin to back off its lofty expectations for hikes. That said, the markets have seen this story before. If the economy slows or the sharemarket collapses, the Fed will be forced to change. Otherwise, the Fed will continue to push its current agenda and risk markets will grow increasingly uncomfortable.

FURTHER INFORMATION

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