Insights from the CIO

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WHY IT MAKES SENSE TO INVEST IN TREASURY BONDS – THE ECONOMIST

The general media flow around bond markets is considered to be decidedly negative at present, particularly in Australia where shares hold a cult-like status. However, it is widely accepted that from a portfolio construction perspective, a broad allocation to fixed income (bonds) plays a critical role. Bonds complement growth assets, whilst high grade bonds (treasuries) can improve asset quality, lowering risk which can help to dampen overall portfolio volatility.

In stark contrast to some anti-bond commentators' predictions (and surprising to most), Australian high grade bonds performed positively over the past two years, with the AU Treasury Index up 1.70%.

Elsewhere, it is pleasing and rare to see third party media (The Economist) reflect on the advantages of an allocation to government/high grade bonds. The Economist published an article – Why it makes sense to invest in Treasury Bonds (26 May 2018) stating, "there is a large class of investors for whom long-dated Treasuries have an almost unique virtue…it consists of holders of other riskier assets, such as stocks, houses or high-yield corporate bonds, who wish to hedge against falling prices in the event of a recession…and this insurance policy pays 3.00% a year."

JCB's April 2018 monthly update suggested "3.00% U.S. 10 year yields, over hyped but a natural target" and The Economist goes on to explain this: "yields on Government bonds now compare favourably with the paltry dividend yields on stocks or with rental yields on prime city property. But why buy a volatile ten-year (or nine-year) bond with a mere 3.00% yield?"

The answer lies further in the article:
"A true diversifier pays off when you really need it – when trouble strikes. In bad times the scope for fiscal stimulus in America would be limited by an already large budget deficit. The Fed would cut short-term rates, perhaps to zero. It might start buying bonds again. Investors would rush to the safety of Treasuries. Ten-year yields could plausibly fall to 1% or so. Those who had bought at yields of 3.00% would secure a 17% capital gain. Not only would that cushion a fall in the price of stocks, it would provide the means to buy them while they are cheap."

2018: THE YEAR OF RISK MARKET ACCIDENTS – INDEPENDENT OR CONNECTED?

Only five months into 2018 and already we have experienced a volatility complex explosion (VIX), LIBOR-OIS funding crisis, trade wars, emerging market stress in Turkey/Argentina and now possible far reaching Italian populism. Are these random singular occurrences to be dismissed as isolated events or linked together with a common thread?

JCB believes these are all episodes of true price discovery in a world where cracks are no longer papered over by excess Quantitative Easing liquidity. We expect more of these spot fires ahead.

What does the VIX explosion, the populist threat to the European Union and Turkish external debt re-pricing have in common? All were tolerated by market players until, quite suddenly, they weren't. For now shares and credit have been spared on a capital basis, however, they have not been immune to the short-term volatility.

As global funding rates continue to rise and market support pillars are further eroded (from Quantitative Easing to Quantitative Tightening), how much longer can credit and equity investors expect to walk the road to wealth creation whilst these risk events are appearing left and right on a consistent basis? Strong U.S. growth remains the narrative on that road for risk investors but cycle tops are approaching. Risk accidents are becoming the normal rather than the exception. Let's hope they remain flares rather than forest fires.

GLOBAL SYNCHRONISED GROWTH HAS ENDED

In late 2017, global growth appeared synchronised to the pleasure of risk markets. 2018 has seen a marked decline in such a view. The Eurozone is leading the slow-down to below-average growth with its economic surprise indices (which measures objective and quantitative economic news) now approaching -100, a severe absolute reading. Asian growth remains patchy, with China and Japan showing signs of slowdown, whilst U.S. growth remains on track. Despite this global slowdown, the U.S. Federal Reserve is near certain in its path for U.S. interest rates as the domestic economy continues to perform. Seemingly, the U.S. Federal Reserve is relying on the ultra-positive soft data surveys for inflation expectation, wages and economic growth even though hard data has failed to keep up in pace.

NOWHERE TO HIDE IN 2018 – LOW YEAR TO DATE ASSET RETURNS WITH LOW FORWARDS EXPECTED

2018 is proving a tough year for various asset classes. As at the end of May 2018, U.S. equity markets are mixed with the Dow Jones down by 1.23% and the S&P500 Index up by 1.18%. U.S. investment grade credit returns were -2.71% and U.S. Government Bonds -1.10%. Emerging market returns are broadly negative in both equities and fixed income, as are domestic equities with a slight drawdown of -0.90%.

As funding rates continue to rise and further Quantitative Tightening flows into markets, forward looking expected returns remain far slighter than the previous decade. Sydney and Melbourne property markets continue to cool as credit conditions are tightening across the economy. From excess liquidity to true price discovery, from accommodative interest rates to restrictive rates, from one-off sugar hits of tax reform to paying the debt laden bills thereafter. Investors will need to consider how they navigate a road that may be fraught with danger as risk becomes common place. Return 'on' capital can quickly evolve to return 'of' capital.

FURTHER INFORMATION

JCB is an investment manager partner of Channel Capital. To learn more about JCB and their investment strategy, please contact Channel Capital.

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