CIO Market Insights

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MID-YEAR REPORT ON JCB'S MAJOR PREDICTIONS OF 2018

- Australian high grade bonds continue to 'defend and protect' despite global interest rates rising
- RBA on hold in 2018, 'out-of-cycle' mortgage rate hikes to continue as funding costs grow
- 3.00% U.S. Treasury yields – overhyped, but natural target
- Continuing global funding pressure is building with global data peaked in February 2018 – is this the year of the USD?

WHAT JCB EXPECTS LOOKING AHEAD INTO THE SECOND HALF OF 2018

- Market calls for RBA rate cuts to grow – asymmetry of rate outcomes have already been removed by the RBA
- A 'new' global asset class called cash – watch 'flow of funds' implications from emerging markets
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MID-YEAR REPORT ON JCB'S MAJOR PREDICTIONS OF 2018

With the kids now on school holidays and the financial year drawn to a close, it is a natural time to reflect on the year to date. It has been, so far, a year of transformational markets driven by populism, politics and policy. Tectonic plates are shifting under the market, and investors are rightly nervous. Despite nearer term fluctuations, U.S. equity markets still remain close to record valuations while looking fatigued. Meanwhile, Quantitative Easing (QE) is being withdrawn and interest rates are rising which has the potential to cause currencies to materially reprice whilst inflicting pain on emerging markets.

Below we take stock on JCB's major market predictions to date, and make some predictions for the year ahead.

- **Australian high grade bonds continue to 'defend and protect' despite global interest rates rising**

Australian fixed income markets remain heavily influenced by global factors, none more so than the U.S. Federal Reserve's intention to continue raising interest rates. JCB has expected headwinds from such a U.S. policy, but we have always argued that Australian high grade bonds would continue to 'defend and protect' and that asset quality is becoming increasingly paramount, in this environment.

For the year to date, high grade bonds (1.80%) have again outperformed cash (0.92%). Given the liquidity and AAA ratings of high grade bonds, on a risk-adjusted basis, this has resulted in great outcomes for investors. Importantly for portfolio construction, high grade bonds have demonstrated negative correlation benefits in stressed market periods – during the volatility complex explosion in February, risk assets weakening in March, the recent Italian political concerns, and President Trump's trade war rhetoric.

- **RBA on hold in 2018, 'out-of-cycle' mortgage rate hikes to continue as funding costs grow**

JCB's central thesis has remained that the RBA has become snookered and that without a collapse in the Australian currency, the RBA will likely be unable to raise domestic interest rates anytime soon. JCB continues to expect that 'out-of-cycle' mortgage rate hikes will tighten domestic financial conditions, something that we are again experiencing due to higher funding costs, as a result of higher U.S. interest rates.

— **3.00% U.S. Treasury yields - overhyped but natural target**

Long dated U.S. Treasury yields have been the subject of much discussion and the expectation since Trump's ill-timed fiscal expansion. Yields briefly breached the 3.00% level, remaining higher for 10 of the 182 days in the first half of the year. JCB remained of the firm view that this was a target rather than a tipping point, and that underweight portfolio allocation gaps should be closed in fixed income, until such improvement in asset valuations.

In a nearer-term context, JCB did concede that a disorderly 'crescendo' sell-off was possible, and that a game plan should be established to further extend allocations at a level above 3.00%. This is so as a further sell-off would require additional new expected rate hikes to be added to the U.S. Federal Reserve dot plot series, an outcome which is not sustainable under current debt loads. Any material extension above 3.00% offers opportunity for investors seeking to increase defence in a diversified portfolio.

— **Continuing global funding pressure is building with global data peaking in February 2018 – is this the year of the USD?**

To round JCB's major market predictions, we maintain the view that funding pressure has risen and will continue to rise. Flash points have been experienced in isolated emerging market countries to date. However, JCB expect funding will become problematic as the late cycle stage unfolds. The implication for investors is that this requires careful consideration for liquidity management and portfolio exposure.

The fairy tale notion that global growth was synchronised lasted only a few months (peaking in February 2018). Since then, European data has collapsed and Asian data has been patchy, whilst U.S. data remains the shining light. In short, 2018 remains the year of the USD, due primarily to interest rate differentials. Interest rates in U.S. markets are at their highest levels versus other G7 nations in more than 20 years, and funding rates in the U.S. look certain to continue higher. This will likely further draw international capital into USD assets and generate USD demand. This effect will be combined with the USD repatriation of offshore corporate profits – all of which should continue to support the USD.

WHAT JCB EXPECTS LOOKING AHEAD INTO THE SECOND HALF OF 2018

— **Market calls for RBA rate cuts to grow – asymmetry of rate outcomes has already been removed by the RBA**

With housing prices cooling, credit availability declining and the Banking Royal Commission findings still to affect the domestic economy, it is unsurprising that the RBA has removed the phrase "the next expected move in interest rates is likely to be higher." The next move in interest rates will be predicated on incoming data and sentiment, and it is good to see the RBA acknowledges that we face downside and upside risks. As the 'ATM of housing' continues to cool over the second half of the year, JCB expect market commentators to begin to call for lower RBA cash rates to offset the rise in out of cycle hikes, due to higher global funding.

— **A 'new' global asset class called cash – watch 'flow of funds' implications from emerging markets**

TINA – the acronym for 'there is no alternative' has applied to many investment decisions in a post-GFC world, where cash rates were essentially cut to zero or below in the developed markets of U.S., Europe and Japan. This has dislodged natural risk-free asset owners who require income and has forced investors up the risk curve into investment grade credit.

The same 'flow of funds' concept works equally well in reverse, as investors rediscover a semi extinct asset class in USD cash. Some short dated U.S. Treasury bills now yield north of 2.00%, whilst relatively low duration bonds are higher than 2.55%. The pricing cycle dictates that a reversal in that flow of funds back into assets of cash and short dated bonds can create quite a stir. Emerging market performance has experienced the 'up the staircase' rally of slow and accretive performance, as sponsorship wanes watch out for the 'down the fire pole' moment.

— The oldest story in finance – the U.S. Federal Reserve will over tighten interest rates, will it cause a recession?

“For the want of a nail the shoe was lost, for the want of a shoe the horse was lost, for the want of a horse the rider was lost, for the want of a rider the battle was lost, for the want of a battle the kingdom was lost, and all for the want of a horseshoe-nail.” Benjamin Franklin.

Which interest rate hike will be the straw that breaks the markets back? Every cycle of the last 50 years has come to pass because of a rising cost of capital. The U.S. Federal Reserve is very intent on continuing to raise interest rates when at their last meeting they confirmed a faster pace of hikes for 2018 at four expected rates hikes. The financial dominoes are lined up, the signposts are clear, now it is just a matter of sequencing towards the slowdown.

— The U.S. yield curve may signal potential recession timing

If you are not already reading about the U.S. yield curve shape in the financial media, you should expect to hear plenty more about it in the months ahead. When the ten year bond yield falls below that of the two year bond yield, the U.S. yield curve is flat, rather than having an expected positive slope that rewards investors with higher returns for taking on more time risk (the time value of money). A flat yield curve isn’t very exciting, other than to indicate that buyers of longer dated bonds expect interest rates to be the same yield as short rates or lower than current short rates, in future time.

What is more interesting about a flat yield curve is that every time (barring 1967) the ten year bond yield went below that of the two year bond yield, the U.S. had a recession in the following six to nine months. At the start of 2017, the difference in these rates was 1.25%; at the start of this year 0.52% and as at 29 June 2018 it was 0.32%. This trend is powerful and an excellent marker for financial and economic health.

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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