Hi and welcome to Conversations, a monthly podcast from GSFM. The series will focus on investment concepts and outcomes of interest to you and your clients.

Our first series focuses on income. At a recent industry event, John Maroney CEO of the SMSF Association commented that there's "tens of billions of dollars sitting in cash in term deposits for people in their 60s, 70s, 80s". While retirees are very keen on stability of capital, they need income – and over the past 10 years or so, cash has not delivered. Interest income aside, where do investors go in their search for income?

Today's podcast features GSMF's CEO Damien McIntyre and investment strategist and rates and bond expert Stephen Miller. Together they'll look at the income landscape – where we are and why we're here…and where it's likely to go next. The next podcasts in this series will feature conversations with a number of our investment partners to examine generating income from fixed income, Australian equities and global equities.

Before I hand over, I need to read this **important notice**:

The information contained in this podcast is general and does not consider your objectives, financial situation or needs. The information and views contained in this update reflects, as of the date of recording, the current opinions of the participants and are subject to change without notice. Before making an investment decision in relation to a Fund, investors should consider the appropriateness of this information, having regard to their own objectives, financial situation and needs. This podcast was recorded on Tuesday October 12, 2021

Over to you gents.

Damien McIntyre

Thank you Tracey and welcome everyone to the GSFM podcast series. As Tracey mentioned, the objective is to prevent flies is a series of conversations with seasoned funds management professionals to share their insights into the asset classes that they have made their own.

As we know, Australia has an ageing population and demands for income from this ever increasing cohort of people is huge. We also have high levels of household savings presently as a result of this COVID crisis and a lack of spending on behalf of the population, so this only adds to increase the demand for income products. However, unfortunately there's not much on offer.

When we look at the level of bond rates, and in particular when we look into term deposits…I noticed this morning that you can get the princely sum of 35 basis points on a 12 month term deposit at the CBA. Investors are really stuck with this dilemma remove of low absolute rates.

Adding to that, inflation only exacerbates the situation; even if we worked on inflation rate of the aim of 2%, we have significant negative real yields. And if the inflation genie is out of the bottle, this is only going to make the situation far worse.

So joining me this afternoon, as is Tracey mentioned, is Steve Miller. He is formerly the Head of Australian Fixed Income at BlackRock and before that Merrill Lynch and the old Bankers Trust, but he's been investing in the bond market for over 35 years.

Steve, good afternoon. With this is the backdrop, what does this mean for bonds?

Stephen Miller

I think you have shaped the question well; we're in unprecedented territory when it comes to government bond yields and for that matter, credit bond yields. As you have articulated, the problem then is not even that yields are so low as to not generate sufficient income, but there starts too, to be concerns about whether they have the right defensive properties in the context of a multi asset portfolio.

So, there's two elements to this; we sometimes in the investment world use the terms defensive and income interchangeably and I think we have to be careful because those two terms aren't interchangeable, they are they have slightly different connotations. So that's the first thing.

The second thing if we're focused on income, as you said we've traditionally done this via bonds, and we have traditionally done it via government bonds, then why don't we buy government bonds?

Well generally, because during periods of crises, they do have better defensive properties. Credit bonds can provide you with income, but you must be able to tolerate slightly more volatility in your underlying capital.

Getting back to your original question, where are we with bond yields? Well, a) they are close enough to historic lows, they've risen a bit recently and b) again you mentioned this in your in your introductory remarks, we're in a fork in the road with inflation.

Now there's a bit of debate in markets about this, you know there are some – myself included – that worry that inflation might be a bit more persistent and worried that the inflation genie can get out of the bottle and worried that we might not be stopping at two or three or four, but we might be stopping and plateauing and not coming down at something a little bit higher than that.

That's the first question. So you're looking at negative real yields and so any income you get is going to be way short of the inflation rate, so that looks to be a problem. The second thing is, if there is inflation, then we will get yields to adjust. But during that adjustment period, as inflation takes hold, expectations adjust, bond yields rise, investors are looking at potentially, reasonably large negative mark to market movements in their capital.

So that's the dilemma. There are lots of ways to skin that cat, maybe we can canvass some of those as we go on.

Damien McIntyre

Yes, duration really is, this is the concept you were discussing a moment ago Steve where if you're the holder of a bond today and the 10 year rate for example were to rise, you've lost money and a lot of investors in bonds on a mark to market basis don't necessarily expect to lose money in bonds, do they?

Stephen Miller

Let's be clear about this, probably up until a year or two ago, in a multi-asset portfolio, the typical 60/40 equities/bonds and you constructed it with ETFs, that is a pretty well balanced portfolio. By and large, through most of this century, bond returns and equity returns have been negatively correlated, so that's been great because bonds being defensive and they've been able to provide you income. That's all good.

Now the problem we've got now is if you're investing in an ETF, you are passively accepting the characteristics of the index to which that ETF is measured. So let's say we were benchmarked against the government bond index, it's fine, high quality credit so no real concerns on that front, but what you do have is you have a duration of that index.

On the Australian market, that’s around five years. So if you have a duration of five years that means for roughly every one percentage point rise in bond yield, you cop a 5% capital loss. So that's what you're looking at now. A good active manager might reduce that duration; typically not close enough to prevent any capital loss, so once you buy an ETF you're passively accepting its characteristics with respect to duration. If it's got a duration for five years – the global ones have even longer duration – then if bond yields rise sharply, you will suffer capital losses in your portfolio.

This is the dilemma. Going back to your earlier point about inflation and the defensive characteristics of bonds we’ve been talking about, it's true that was for most of this century, the 21st century, bond returns and equity returns have been negatively correlated.

For most of last century, they were positively correlated and sometimes in a bad way. Bond yields rose and equity markets fell and if we do get a sustained period of inflation where central banks have to jam on the brakes and bond yields rise sharply, it could well be happening at the same time as equities falling.

We need to get a little bit smarter about diversification and we need to get a little bit smarter about how we diversify that defensive part of our portfolio, and we need to get a little bit smarter about how we deliver income in a defensive context.

Damien McIntyre

So in that defensive context, how do you believe absolute return fixed income products can fit into that into that approach?

Stephen Miller

Well, the attraction of absolute return or unconstrained fixed income type products is, unlike as I mentioned with say an ETF which is benchmarked to a an index, and you have to passively accept the duration or the interest rate sensitivity of your capital to that index, absolute return portfolios typically have much, much, much lower duration. They are generally managed to a cash benchmark, they don't seem to extract all their return from duration positioning or for that matter, credit positioning.

So what they are trying to do is use manager acumen to generate income through selected exposures to maybe credit, to maybe emerging markets, to maybe inflation linked bonds, which are very appealing if one is worried about inflation staying high in the future. They use high credit quality securitised assets, currency positioning; all these things can feed into an absolute return portfolio, but importantly, it's not passively accepting the properties have been given benchmark, not passively accepting the duration of a benchmark.

Absolute return duration is typically much lower, so that's a good thing to have if bond yields are rising and secondly, they don't passively accept some of the credit attributes of certain ETFs that have credit in their benchmarks.

So while you're not going to knock the lights out in a return sense with this, but as an alternative to conventional bonds or conventional bond benchmarks, an alternative defensive asset that can give you income whose attraction is arguably increased if we are going into a period where bond yields might march sharply higher as a consequence of inflation or whatever else.

When I say whatever else I'm not being flippant; bond yields are close enough to historic lows so it's not axiomatic that they have to rise, but there are a number of reasons why we should be nervous about that prospect.

Damien McIntyre

The great thing about those absolute return products is that the fund managers have so many different assets or tools at their disposal; as you say, inflation linked bonds, floating rate securities,

Stephen Miller

They can be particular about what credits they want, they can be particular about what emerging markets exposures they want, they can use currency, a lot of them too can utilise a little bit of insurance to explicitly guard against downdrafts.

For example, a number of these absolute return or unconstrained products can use credit default swaps to mitigate the impact of any credit event upon the portfolio. Generally they have access to a broader array of instruments, they can pull or push any broader array of levers than what might be typically available, certainly from an ETF, or even from your bog standard active fixed income product, which after all is managed to benchmark.

Damien McIntyre

So looking at the interest rate market generally, and I'm talking about cash rates as well as bond rates, where have cash rates been and how are central banks managing?

Stephen Miller

That's a good question Damien. I might be giving away my age here, but I remember sitting at a bank economics test back in the late 80s and I think the cash rate in Australia at stage was 17.5% and the market expectations at that time were for it to go to something like 21 or 22%.

So, that's where cash rates were, you know we're going back 30-35 years. And where they are now is close enough to zero, and around the world they're close enough to zero and in some places as we know, have been negative.

That is unprecedented. Is it not only unprecedented within the lifespan of, let's call it seasoned investors or seasoned participants in financial markets like you and I, but that's more or less unprecedented over a period of 100 years. So, cash rates are low and bond rates are low.

Bonds are slightly off their historic lows, but in a number of places – Germany, Switzerland, Japan – we've had negative bond yields. So try and get your head around - what you do is you are paying the government to hold their bonds. Ten year bond yields in Germany are minus 20 basis points for the pleasure of owning a 10 year German government bond, you pay the German government 20 basis points. That doesn't seem smart – if you buy the bond and hold it to maturity, you guarantee yourself a loss.

Where rates were 30-35 years ago, that was probably unprecedentedly high, but where they are now is unprecedentedly low.

There's been people around, myself included, that every now and then get nervous about inflation and thought bond yields might spike up, but that hasn't happened. But I think since the period of the great disinflation through the 90s and for most of this century, I think the risks are weighted toward the upside of inflation more so than any other time since the late 80s.

I think if you accept that, you have to say the risks are weighted toward higher body yields more than any other time since the late 80s. So, that's the conundrum that we're looking at this point in time.

Damien McIntyre

Yes it is a conundrum considering that not only have governments gorged themselves on issuance at such low rates, so too have corporations through credit securities all over the world.

Stephen Miller

Sure and why wouldn't they? After all, that was the intention central banks, they wanted investors to get out of government bonds and start buying credit bonds, start buying equities in order to get the economies going again, to fund if you like, private sector expansion. But it's interesting when it comes to credit bonds. You know, I said at the start, we sometimes use defensive and income as meaning the same thing, but there are subtle differences and that's the case when it comes to credit bonds.

Credit bonds generally can provide you with good income, but in certain circumstances, they are not necessarily a defensive instrument of each trip because again you can have big mark to market capital losses in your investment while still delivering the income.

Obviously, if the credit doesn't go broke that's all fine, to leave the capacitor where that mark to market movement occurs, and not all investors do, credit is not necessarily a good defensive investment but it's a good income investment. If investing in credit bold or corporate bonds, I think you can have to be mindful that you can have big negative mark to market movements in your capital.

We saw that briefly through the GFC, typically with certain back bank issuants, where there was big negative mark to market movements in the capital price of bonds issued by banks, but they continued paying income. If you held on, well and good that's fine because the capital price has appreciated again. But if you couldn't, or were looking at income or had to redeem, you were crystallising some big losses on your portfolio. Yes, credit can provide income, but don't get that confused with it being necessarily a good defensive asset.

Damien McIntyre

So in terms of interest rates and inflation, we were in an incredibly interesting moment in time in the world’s history, where we had this horrible COVID event last year which for a period of time slammed the brakes on production and the movement of goods all over the world, which created supply issues which are now filtering through to higher inflation numbers. We've even got companies being so bold as to say that they’re unconcerned about putting their prices up, which is unique in the history or the context of the last 20 years.

So, where do you think we are in this inflation narrative, for want of a better description. What do you think is the likely outcome as we roll through the next year or so?

Stephen Miller

Look, I am a self-confessed inflation worry wart, I have been worried unnecessarily on occasions in the past. I am worried this time around though, and I think as I said earlier, I think there is an argument – and a very good one – that said the inflation portents now are as negative for higher inflation, or pointing toward higher inflation, in a way they haven't done going back to the 70s and 80s.

Now, you mentioned supply constraints. Some people, including some central bankers, will assert that look you know because it's supply, it's all transitory, it doesn’t matter, inflation will flip up and will come back down again, don't worry.

The Fed told us that back in March when they forecast their preferred measure in place, the core PCE to be 2.2% for 2021. They revised that up again, to about 2.8% from memory in June, and then recently revised it up again to 3.7%.

So basically, inflation 2021 is going to be close to double its target and close to double what it was forecasting at the start of the year. So that’s the first thing to bear in mind.

The second thing is to look back to the 70s; you know, the initial inflation boost then, or a large part of the inflation boost, did come from supply shocks, namely the oil shock. And what happened then was that central banks accommodated the oil shock and fed into expectations that started to change price and wage setting behaviour, which meant that it adopted an air of permanence.

The worry is, that's happening now. Not on the scale we saw the 70s, I'm not saying that, but the worry is now inflation can only be transitory if it doesn't affect the price and wage setting behaviour.

But as you mentioned, firms are putting up prices, they're seeing other firms first put up prices, so they're all doing that. There are labour shortages and acute labour shortages in many areas of the global economy, so workers, quite naturally, are demanding higher wages, which is what the textbooks tell us should happen.

So, I wonder whether inflation is as transitory as some of the central banks assert, because at the moment we're seeing evidence, anecdotal evidence, that it is wage and price setting behaviour. That's more obvious in places like the US, Europe and the UK than it is in Australia, but my own view is that it will occur here. So once it starts doing that, that's when you start to worry about the inflation genie getting out of the bottle; and once it's out of the bottle, it's bloody hard to get it back in.

We saw, back in the early 80s, where Paul Volker had to raise interest rates; from memory, they went to close to 20% in order to snap the inflation stick and get price inflation and wage inflation back to more manageable levels that were more conducive to a better functioning of the economy.

So I do worry about inflation. I think there's another couple of things to worry too. You talked about household savings and that's true here and is true elsewhere as well. Once we get through this, there's going to be a lot of spending. Others point to some structural elements that mean that inflation bets are bit more two-way, rather than one way that is down.

A former Bank of England Monetary Policy Committee member Charles Good-Harding, a very distinguished professor at the local School of Economics, and former Morgan Stanley economist Manoj Pradhan wrote a book[1] saying one of the big reasons we had declining inflation, let's say since the Berlin Wall fell, is there was unprecedented globalisation in both goods and labour markets. You think of all those highly trained Eastern European workers being able to travel the world, at the same time we had a lot of outbound skilled workers from China and India and the likes, all leading to, if you like, a wage shock which depressed wage growth.

That process has largely run its course. Baby boomers are now at a level of peak participation in the work force; they're leaving the work force so those things that drove wages lower over the last 30 years are on the cusp of reversing. That might mean, right at the time we're getting these supply shocks from the pandemic, we're also getting structural reasons inflation – or why these inflation suppressors are no longer so powerful.

At the same time too, where we're seeing a push for greater regulation of product and labour markets, which will raise business costs and add to inflation pressures, so yes I am worried. I am not saying we're going into a 70s replay, but I am worried that we might have to get used to slightly higher rates of inflation, more than what central banks have targeted or are forecasting, for an extended period.

Damien McIntyre

This is probably unkind, but I describe quantitative easing and this participation of central banks in bond markets around the world to manipulate interest rates lower…I once thought of that as the most elaborate experiment, economic experiment, in my lifetime. I have always been curious to see how that plays out. Surely, with prospect of rising inflation, this only intensifies the pressure on central banks and governments given their levels of indebtedness.

Stephen Miller

Is it the job of central banks? You know, we don't know what the counterfactual is. So, if they hadn't done QE, we may well be in a worse circumstance. I think that's the first thing.

I think we could probably say that the experiment looks to have been successful in preventing perhaps even worse outcomes and in mitigating a more extreme form of dislocation as a result of the

[1] The Great Demographic Reversal Ageing Societies, Waning Inequality, and an Inflation Revival

pandemic. But there were always going to be exit problems when it came to exiting from what are emergency settings in monetary policy.

I think the other thing that central banks have had to contend with is they haven't got much help from other forms of policy. They are now in the form of fiscal health, we've seen that here in Australia, we've seen it in the US and the UK, Canada and we've even seen it in Europe where for institutional reasons, it's been a little harder to enact.

The help did come but it was a bit late, and it wasn't always optimally targeted, if I can put it that way, so that's the first thing. The second thing, and this is where this notion that because it's supply side it's temporary, is a little bit dangerous. But we're seeing some sort of backsliding on some of the market based reforms, particularly the product and labour markets, that were made in many economies through the 80s, 90s and into the 2000s – as I say, that's sort of reversing now, there's a greater desire for whatever reason, for greater regulation.

I wonder whether a) that's going to be effective and b) that it's going to mean that we go back to the sorts of economies we had in the in the 60s and 70s, that were a little bit sporadic and not very flexible, prone to having supply shocks manifest themselves in more persistent inflation. So, I don't blame the central bankers, I think the experiment was the choice is between a rock and a hard place, I think the experiment has largely worked and done what it set out to do. I do think there are exit problems, I think the problems are being compounded because central bankers had always had support from other arms of policy, including fiscal and including structural supply side type policies. I think that that's where we are potentially going to have to put our thinking caps on about a) what happens to inflation and b) how do we construct portfolios there better protect our invesetments from the ravages of inflation.

Damien McIntyre

Yes, and that takes us back to where we started really. Government bonds in a rising interest rate environment need to be treated with great caution.

The great thing about a bond investment is that if you hold to maturity, you get your money back, 100 cents in the dollar, and a coupon along the way. Unfortunately, in the unit trust industry, these investments are marked to market every day and investors have to wear that volatility and don't necessarily have, well let's just say the patience, to wait ten years for a $100 return.

Stephen Miller

And some are running down their capital; and if they're running down their capital, that means they have to incur losses. But I think you're right, you raise a good point. We focused most of today's discussion on bonds, but there are, you know for income, there's other products out there that are worth exploring in the current environment. There's a lot of equity based income products, but even sophisticated investors like the Future Fund, they said they're not going to own much in the way of nominal government bonds; their defensive asset of choice is equity income, whether by allocation to consumer staples or something like that.

There are a number of equity income products out there that can be a good substitute for bonds, particularly when you are worried about a fairly large adjustment bond yields to a level where they might become attractive and provide income.

We've talked about absolute return, we've talked about inflation linked, let's not right off equity income as also something investors could look to, to provide them income through this period.

I think it in looking at that though, if you're looking at equity income, looking at defensive equities, don't expect the stellar returns we have seen, they don't generally attach to defensive equities. But, they have that nice attribute that they provide you with a decent amount of income.

Damien McIntyre

They do. And a lot of those mature consumer staple type companies or defensive companies again as we noted earlier on in the conversation, have become more comfortable with putting their prices up. At least they offer investors some sort of hedge on inflation as well.

Stephen Miller

Exactly. They provide some income, they potentially – subject to some other moving parts – they potentially have that stable or stable capital attribute and can deliver income rather than the riskier growth part of the equity complex.

Damien McIntyre

So in summarising our discussion with respect to investments in fixed income and bonds generally, I think we can agree for the time being that we have to look at government bonds with some caution and be careful about the duration risk that investors might be incurring in a rising interest rate environment…but noting, that if interest rates did rise far enough, they would become once again an attractive and defensive asset class.

Stephen Miller

I think that's true, the only proviso I'd add, is what you might want to do is down weight nominal and increase inflation-linked government bonds. That will give you some protection if you're worried about inflation.

Damien McIntyre

That leads us to the absolute return or the unconstrained bond funds where the managers have those tools at their disposal. It's not buying an index blindly, they are much shorter in duration and have those floating rate instruments in their toolbox.

Stephen Miller

Exactly. It's funny, we sit around saying the first lesson of investing is diversification. I mean I think that should apply to the defensive part of the portfolio as well. Don't just think the defensive component should be nominal government bonds, think about inflation-linked, think about absolute return, think about equity income.

You can even think about, if you weren't so desirous for income, things like gold. All those sorts of things I think are important within the bond space or with defensive if you were worried about inflation. Even look at commodities, notwithstanding the fact that they don't offer any income.

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