April 2018

Bad Beta

What has been an ‘interesting’ year for the global economy and financial markets may get even ‘more interesting’ between now and year-end. And that may make it more challenging for investors.

A strong US reporting season that generally exceeded already elevated expectations, and a rosy growth prognosis from the IMF, should have provided the US equity market with a bit of a fillip. However, the breaching of the psychologically important 3% level for US 10-year yields has elicited a bout of ‘hand wringing’ commentary.

It may well be wise to give some attention to that ‘hand wringing’ commentary.

Don’t get me wrong. I am an optimist (for a bond guy). And in that respect, I still think that strong US and global growth momentum and the attendant support for corporate earnings is sufficient to see modest single digit type returns from US and global equities in 2018, further rises in US bond yields notwithstanding. However, the cocktail currently being mixed for investor consumption in 2019 looks troubling.

At its centre is the prospect that bond yields go significantly higher than 4%.

It is worth recalling that when US bond yields were last at 3% in 2014, the Fed funds rate was 0.25%, the unemployment rate was 6.7% and the Fed’s core PCE measure of inflation was running around 1.5%. Fast forward to now, and the Fed funds rate is 1.75% and likely to be 2.50% by the end of year, the unemployment rate is at 4.1% (the lowest since 2000), and core PCE is expected to go beyond 2% very shortly.

Add to that the fact that the Fed is reducing, rather than increasing its holdings of US bonds, and that a budget deficit approaching 5% of GDP is in prospect for 2019 (when the US is close enough to full employment), then the foundations for US 10-year bond yields above 3% are far stronger this time around than they were in early 2014.

Indeed, with that backdrop, 4% US bond yields don’t look that much of a stretch and relative to history would not constitute a ‘high’ yield at all.

What this suggests is that even if one accepts the ‘benign’ scenario that equities eke out mid-single digit returns even as bond yields rise, the risks around that equity scenario are skewed to the downside and involve significantly higher bond yields – perhaps higher than 4%.

What has hitherto received somewhat scant commentary (with some worthy exceptions) is the prospect of a US budget deficit approaching 5% of GDP at a time when the US is at full-employment. This is almost unprecedented in the US in peacetime. While that occurrence may keep a potential recession at bay for a time, the political-economy complications that arise from such a budget stimulus, create more difficulties for policymakers and increase the probability of a policy mistake.

That is nice way of saying that it could well end in tears.

Why?

Firstly, the budget induced stimulus makes the Fed’s task in calibrating the withdrawal of stimulus (i.e. the extent of the increase in the policy rate) even more difficult. It is not inconceivable that increased price pressure as the stimulus is applied to an economy at full employment forces the Fed to hit the brakes harder (take policy rates higher sooner), compounding the likelihood of a mistake.

Secondly, higher budget deficits mean greater bond issuance at precisely the time when one of the largest buyers of bonds in recent years (the Fed) is reducing its purchases – more bond supply and less bond demand leads inexorably to higher bond yields.

Thirdly, and perhaps most remarkable of all, given President Trump's trade obsession, is that a higher budget deficit will likely increase the US trade and current account deficits.

Creating a whole lot of extra demand when the economy is close enough to full capacity inevitably means that excess demand spills over to sucking in more imports. How President Trump responds to this is of course difficult to predict but let's just say the portents aren't good – the President has a predilection for tariff barriers, the imposition of which is negative for the US as well as for the rest of the world.

Incidentally trade barriers have almost no meaningful effect on trade deficits. As an article by Robin Harding in the *Financial Times* of 21 April 2018 points out, what tariff barriers do is reduce the overall volume of trade and shifts it about. He cites studies from the Peterson Institute that point out that countries with low tariff barriers such as Switzerland and Singapore have large trade surpluses while others with comprehensive tariff barriers like India and Brazil have large trade deficits. What actually determines the magnitude of a country's current account deficit is the difference between savings and investment – a budget stimulus widens this gap.

So, despite being an 'optimistic' bond guy, when I gaze into the 2019 crystal ball, I get a little worried (reverting to stereotype?). Yes, growth momentum is currently moving along nicely (if a tad slower than Q1) and that supports corporate earnings, but the looming policy challenges presage a challenging 2019 that could see it all end in tears. This suggests that the outlook for both equity and bond beta is challenging and investors need to incorporate this eventuality into their thinking about portfolios through the incorporation of less (both equity and bond) beta sensitive strategies. That markets can discount these eventualities argues for moving sooner rather than later.

In this context, investors might contemplate some allocation to less beta sensitive equity and bond portfolios. At a very basic level this argues for a focus on active portfolios with proven stock-picking capability. Particularly given that the 'bad beta' scenario almost inevitably involves higher volatility and with that greater return dispersion among individual stocks. It might also encompass allocations to equity portfolios that can mitigate beta risk through some 'shorting' capability.

Bond investors might contemplate an allocation to so-called 'unconstrained' or 'absolute return' bond portfolios. Such portfolios typically have less duration exposure than conventional bond portfolios benchmarked to an index and aren't as negatively affected by rising bond yields. They typically will also seek more diversified sources of return such as exposures to other fixed income sectors, including inflation-linked bonds, corporates, high yield, emerging markets, FX, asset backed securities. The multiplicity of sectoral exposures diversifies risk and can mitigate total portfolio risk. At the same time, such portfolios retain the conservative return profile associated with bonds.

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