Stephen Miller - GSFM Advisor

March 2018

The ‘old normal’ and the President: some thoughts on recent policy announcements

As some of you know, I have been representing the back-up in bond yields and attendant resurgent volatility in financial asset prices as a return to the ‘old normal’. By this I mean the end of the extraordinary support that policymakers generally, and central banks in particular, have provided for financial assets.

Of course, this is entirely appropriate (perhaps even overdue) in an environment where it appears to be the first episode of synchronised global growth since the Financial Crisis. It is my belief that such an environment presages a move in the US 10-year bond yield to something approaching 4% in 2018 and, further, that such a move in bond yields – while certainly a headwind for equity markets – need not mean that equity markets eke out modest returns in the same period, even if it does occur in an environment of higher volatility.

The release of US employment numbers for February showed strong employment growth, but still contained wage growth (albeit on a modest accelerating trend), are not inconsistent with that narrative. Nor was the February CPI report, which was consistent with inflation returning to the Fed’s 2% target in 2018 but not portentous of any serious break-out on the upside. Indeed, as of the time of writing (mid-March), the S&P 500 has remained in modestly positive territory year-to-date despite a circa 40 basis point increase in the 10-year bond yield. In this context, the central narrative remains that the growth outlook itself is the most important focus for equities, rather than the movement in bond yields.

That all seems reasonably benign. And it is. I’ve always found it good practice when confronted with benign prognoses to examine the risks around that scenario. To ask oneself: “What can go wrong?” The answer, unfortunately, is: “Plenty.”

I see three key risks (in order of significance):

1. A US budget deficit at unprecedentedly high levels for a peacetime economy at or near full employment. This occurs as the Fed commences a rundown of its balance sheet - i.e. an unwinding of its huge bond purchases after the ‘unorthodox’ monetary policy in the post-Financial Crisis period.
2. An escalating global ‘trade war’ ignited by retaliatory measures by China and the EU to the recent announcement by US President Trump of tariffs on steel and aluminium.
3. Geopolitical risks, which includes the usual suspects: the Middle East and North Korea, the China/US relationship, an assertive Russia, plus some other nuanced risks such as Brexit (more its execution rather than the event itself), elections in Italy, Brazil and Mexico, and the still present threat of anti-EU populism in Europe.

Let’s take a look at each of these in turn.

US budget deficit / fed balance sheet reduction

There is a large scale fiscal policy change in train in the US, which looks to be of a character that is inappropriate for the phase of the economic cycle given that the US is close to full-employment. President Trump's corporate tax package looks to cost approximately $US1.5 trillion over the next decade, while the recent budget deal agreed by Congress will add some $US0.3 trillion to expenditures over the next two years.

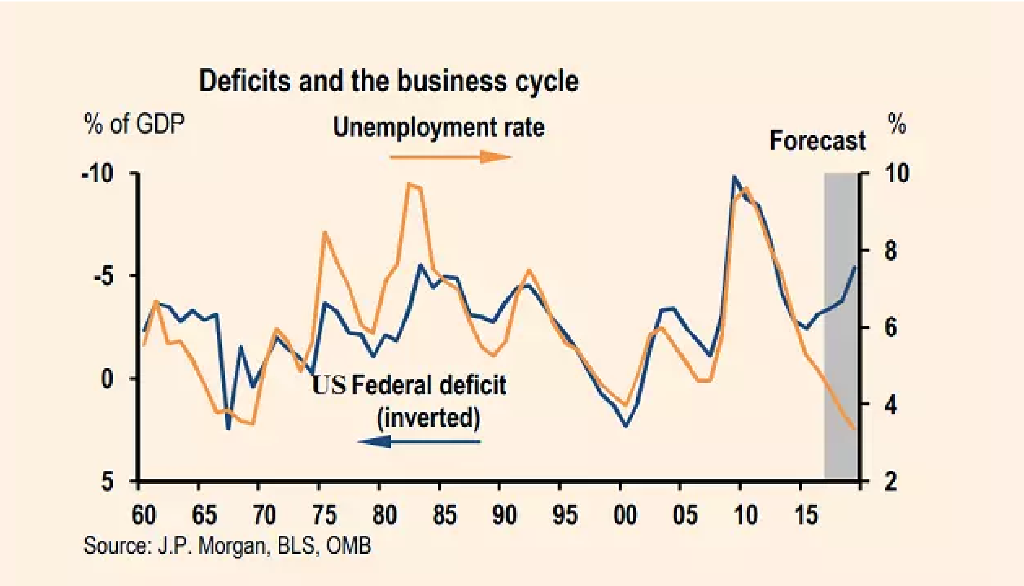
This is not to deny the substantially positive supply-side effects of the corporate tax measures; however, combined with spending increases, these measures imply a fiscal deficit well over 5% of GDP by 2019. That is almost unprecedented for a peace-time US economy at close to full employment.

Gavyn Davies, writing in the Financial Times, notes:

> "[this]...is the first trillion-dollar deficit in America, [and] represents a fiscal easing equivalent to about 2 percentage points of gross domestic product over two years. This will lead to a major breakdown in the normal correlation between unemployment and the budget deficit, as shown below [chart one]. With the unemployment rate headed towards 3 per cent, all past evidence would suggest that the budget should be comfortably in surplus by now."

Mr Davies highlights the following chart from JP Morgan to illustrate the magnitude of the divergence between the US deficit and the unemployment rate.

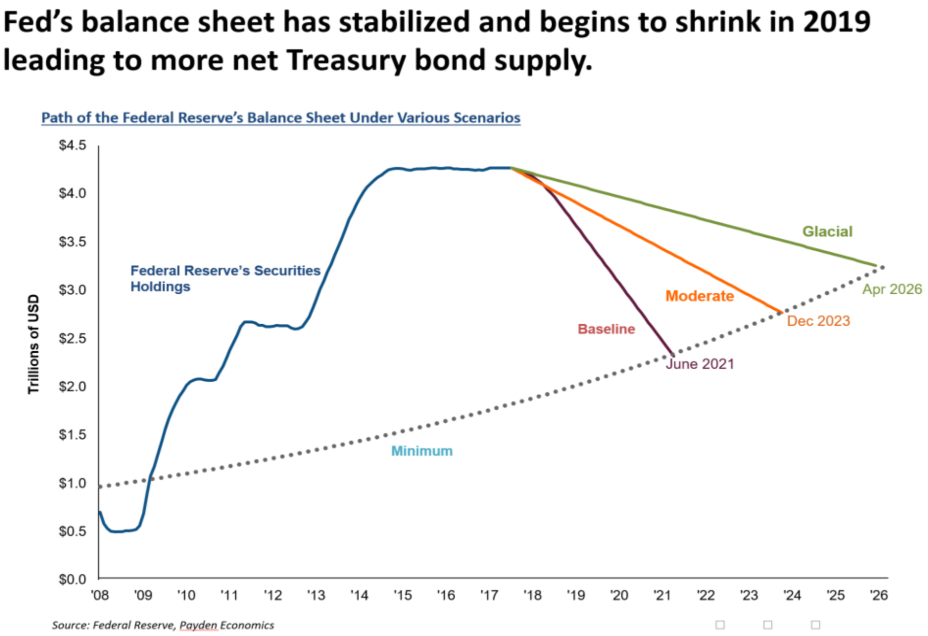
Chart one: The deficit and the unemployment rate



While the historic relationship between the magnitude of the budget deficit and bond yields is by no means a robust one, there is a sound basis in macroeconomics for believing that bigger budget deficits when the economy is close to full employment lead to higher bond yields.

There is simply no requirement to apply such a stimulus to the economy at this stage of the cycle. Doing so means that not only will the US Treasury need to sell more bonds (increasing supply) but is doing so at a time when the biggest buyer of recent years (The Fed) is reducing its balance sheet (reducing its bond purchases) as illustrated by chart two.

Chart two: Fed's balance sheet under various scenarios



Clearly in such an environment the risk might well be that inflation breaks significantly higher than currently expected and The Fed finds itself 'behind the curve'. In this case it has to enter into faster rate hikes, of greater magnitude, than currently priced meaning 10-year bond yields break significantly higher than 4% leading to a tipping point for equities.

Global trade wars

I thought our own Reserve Bank of Australia (RBA) Governor, Phillip Lowe, put it well when he said

> "…protectionism is costly. It's costly to the country that implements the protectionism and it's costly to everyone else".

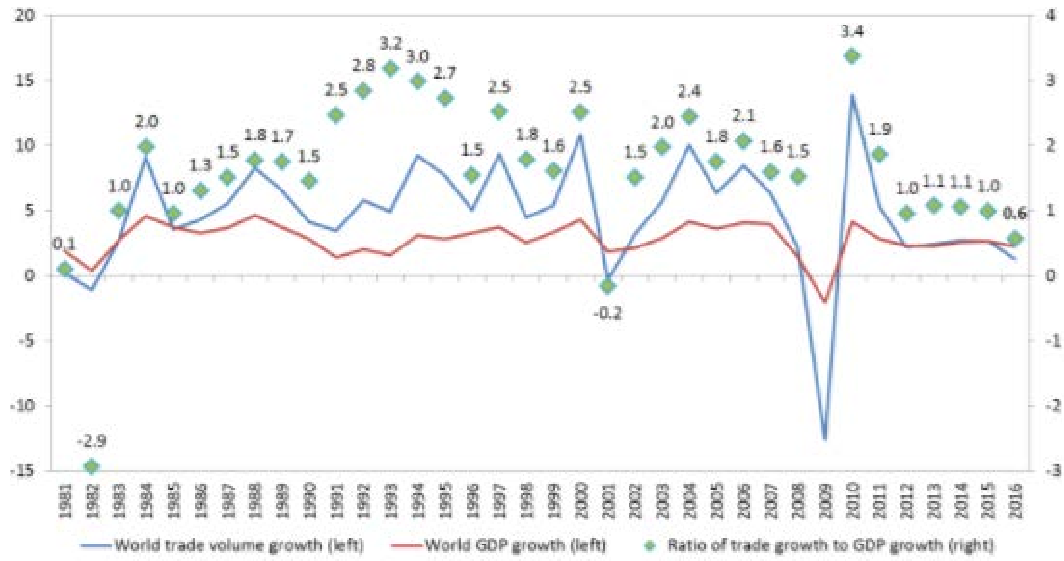
By themselves the measures announced by the US President will not have any discernible impact on global growth. The fear is that they incite retaliatory measures from the major trading blocs, such as China and the EU, leading to a race to the bottom in terms of protectionist measures with an attendant slowing of global trade and economic growth.

As chart three from the World Trade Organisation indicates, reductions in the growth of world trade appear to be associated with periods of weakness in global growth and vice versa.

The Smoot-Hawley Tariff Act implemented in the US in 1930, and the retaliatory responses from other countries, is in some quarters cited as one of the primary reasons for the severity and durability of the Great Depression. Unfortunately, given the mediocrity currently attaching to the global political class, it is by no means certain that we won't see the emergence of an internecine trade war which upsets the positive global growth momentum that has characterised the start of the year.

The departure of Gary Cohn as Director of the National Economic Council and the sacking of Rex Tillerson as Secretary of State means a paucity of adults in the room. The attendant increased sway of protectionists within the US Administration has increased the risk that the President's more egregious protectionist proclivities are not so restrained in the future.

Chart three: Ratio of world merchandise trade volume growth to world real GDP growth, 1981-2016 % change and ratio



Sources: WTO Secretariat for trade, consensus estimates for GDP

An increase in global protectionist tendencies is not only inimical for global growth but implies higher prices and less economic flexibility leading to, for a time at least, more inflation pressure. This may well imply higher interest rates for a given economic growth rate. Such a cocktail is not one that is typically conducive to financial asset returns. In such an environment higher bond yields may well lead also to an earlier tipping point for equity market performance and challenge the view that US equities can withstand US 10-year bond yields approaching 4%.

Geo-political risk

Geo-political risk is always with us. Moreover, such risks are mostly unforecastable and by definition, a ‘shock’ when they occur. Nevertheless, some obvious candidates present themselves:

- Tensions on the Korean Peninsula. Admittedly these seem to have abated recently with what passed as a ‘charm offensive’ by the North Koreans at the recent Pyeongchang Winter Olympics and the surprise (some would even say stunning) possibility of a summit meeting between US President Trump and North Korean Leader Kim Jong-Un.
- The China/US relationship. Again, the issue of tariffs aside, the ‘heat’ seems to have gone out of the military/strategic dimensions of US/China interactions. As former Australian Prime Minister Paul Keating commented in early March, President Trump shied away from a more traditional US policy of seeking strategic dominance, and instead showed himself to be pragmatic about China’s rise. And with North Korean tensions apparently abating, that might well continue. To be sure the tariff debate is a prickly one and a reminder that there may be ongoing areas of tension with China, even if the traditional sources of tension are diminishing.
- The Middle East is a perpetual source of tension and there does appear to have been a ratcheting up of tensions between Israel and Iran (and its proxies) in recent times.
- An assertive Russia complicates any geo-political calculus. This takes the form of alleged Russian interference in the 2016 US Presidential election (as well as other elections in the West); the Russian involvement in the assassination of a former Russian double agent in the UK; and continuing tensions with neighbours from the Ukraine to the Baltic States.

- A poorly executed ('hard') Brexit is an issue both for the UK and European economies. Anti-EU inspired populism continues to bubble away in the background. The Italian elections were a timely reminder that this is going to be an ongoing issue, as was the protracted process in Germany around the formation of a government.
- Elections in the important Latin emerging economies of Brazil and Mexico later this year also bear watching.

Investment implications

As mentioned, the central thesis is that the growth outlook remains the key focus for equities rather than the movement in bond yields. My central expectation is that bond yields move toward 4% but that doesn't prevent equities (in a point-to-point sense) from eking out modest mid-single digit type returns over the year, albeit in an environment of greater volatility (or reduced reward for risk). On the surface, this implies a preference for equities over bonds but given what I regard as the key risks on the horizon, there is a requirement for some circumspection in the implementation of that view.

Perhaps an implication of the forgoing is to be cautious of too much exposure to both bond and equity 'beta' and look at introducing absolute return strategies into portfolios.

This can include a contemplation of exposure to hedge funds (ideally those uncorrelated with the fluctuation's risk sentiment) should risk appetite extend to that sector.

More importantly, however, for bond investors it underscores the importance of contemplating an allocation to so-called unconstrained bond portfolios, more as a complement to traditional bond portfolios benchmarked to a conventional index – such as the Bloomberg Barclays Global Aggregate or the Bloomberg AusBond indices – than a replacement.

Unconstrained portfolios typically have less duration exposure than conventional bond portfolios benchmarked to an index. 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, and asset backed securities.

The lower duration exposure tends to benefit performance in a rising interest rate environment, while 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.

The Payden Global Income Opportunities Fund (the Fund) is an actively managed fund that provides investors access to a highly diversified and well-researched portfolio of global fixed income securities. Its unconstrained investment strategy gives the fund the flexibility to dynamically alter its investment mix to find the best opportunities across securities, duration and geography. The Fund aims to generate steady and dependable returns regardless of the market environment and aims to produce a return of Bloomberg AusBond Bank Bill Index + 250 basis points (after fees) over the medium term.

For more information about the Payden Global Income Opportunities Fund, please contact:

Damien McIntyre • dmcintyre@gsfm.com.au • (03) 9949 8852 • 0407 266 999

Stephen Fletcher • sfletcher@gsfm.com.au • (03) 9949 8828 • 0400 559 118

Shaun Thomas • sthomas@gsfm.com.au • (02) 9324 4355 • 0450 157 588

Steve Taylor • staylor@gsfm.com.au • (07) 3012 6159 • 0404 092 635

Huw O'Grady • hogrady@gsfm.com.au • (03) 9949 8825 • 0419 200 052

David Blair • dblair@gsfm.com.au • (02) 9324 4352 • 0410 484 389

Stephen Higgins • shiggins@gsfm.com.au • (02) 9324 4330 • 0407 094 707

Zane Leyden • zleyden@gsfm.com.au • (03) 9949 8860 • 0419 116 626

Matthew Ferguson • mferguson@gsfm.com.au • (02) 9324 4342 • 0449 103 640

gsfm.com.au

Important information

Bloomberg Finance L.P. and its affiliates (collectively, "Bloomberg") do not approve or endorse this material and disclaim all liability for any loss or damage of any kind arising out of the use of all or any part of this material.

The information contained in this article reflects, as of the date of publication, the views of Grant Samuel Funds Management ABN 14 125 715 004 AFSL 317587 (GSFM) and sources believed by GSFM to be reliable. We do not represent that this information is accurate and complete, and it should not be relied upon as such. Any opinions expressed in this material reflect our judgment at this date, are subject to change and should not be relied upon as the basis of your investment decisions.

Grant Samuel Fund Services Limited ABN 48 129 256 104 AFSL 321517 (Grant Samuel Fund Services) is the responsible entity of the Payden Global Income Opportunities Fund ARSN 130 353 310 (Fund) and is the issuer of this information. This information has been prepared without taking account of the objectives, financial situation or needs of individuals. Before making an investment decision in relation to the Fund, investors should consider the appropriateness of this information, having regard to their own objectives, financial situation and needs and read and consider the product disclosure statement for the Fund dated 22 February 2017 (PDS) and the Additional Information to the Product Disclosure Statement. The PDS may be obtained by contacting Grant Samuel Funds Management on 1300 133 451 or from www.gsfm.com.au. Applications to invest in the Fund must be made on the application form which accompanies the PDS. None of Grant Samuel Fund Services Limited, its related bodies or associates nor any other person guarantees the repayment of capital or the performance of the Fund or any particular returns from the Fund. This document is issued on 20 March 2018.