RIMsec
Fixed Income Specialists

APRIL RESEARCH

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Current Themes

- More quantitative easing announced...its Japan's turn and the yen is down but both Japanese bond and sharemarkets are up and confidence is heading up too…Australian Dollar is through the yen roof!

- European problems reignite volatility in sharemarkets but significant losses have not occurred and markets are still relatively flat…Australian Bond yields are down a little.

- Quantitative Easing policies around the world should still support sharemarkets and other risky asset purchases, although valuations are looking stretched.

Views

Interest Rates

- The latest Reserve Bank statement did nothing to suggest interest rates are doing anything other than stay where they are or decrease in the coming months. Inflation concerns are off the agenda and the focus is maintaining economic growth which will be more difficult than many realise

Credit Spreads

- Whilst credit spreads continue to narrow they are still at relatively attractive levels both in Australia and overseas. However, their rapid fall means that price volatility may be more common as future economic slowdown results in concerns of value.

Australian Dollar

- Whilst there has been mild strengthening against the US Dollar and Euro over the last 6 months, the same can't be said with the Japanese Yen…massive strengthening. Since the start of October, the Australian dollar has increased by around 25% against the Yen…this is a short term negative to the Australian economy given Japan is our 2nd largest trading partner after China.

Views continued…

Volatility

- After 9 months of positive performance the Australian sharemarket finally had a negative month in March. Whilst Euro problems, thanks to collapsing Cyprus banks, was the catalyst; this higher volatility may continue as sharemarket valuations are stretched thanks to continued quantitative easing.

Macroeconomic Risks

- Market risks are more likely to be driven by European woes although any adverse Chinese economic results will impact Australia's economy, share and bond markets the most.

What did the Reserve Bank say?

On 2 April, Glenn Stevens announced the Reserve Bank board "judged that it was prudent to leave the cash rate unchanged" at 3%. So, on face value, you could be excused for thinking any concerns about the end of the Resources Boom may have finished and we're looking good again. After all, our most recent unemployment level was unchanged at 5.4% when many were expecting a higher number; and financial markets have performed well with the Australian sharemarket increasing by more than 10% since the last rate cut in December…so perhaps companies are going okay???

Unfortunately Glenn Stevens continued to paint an economic picture that is still quite bleak with concerns about the lack of strength in the Australian economy moving forward. Key components in the statement were….

The global situation has improved…

- "Global growth forecasts to be below average"…China has "stabilised" and the US "is experiencing a moderate expansion"…mixed news

- "Commodity prices have declined but are still at historically high levels"…given the Australian dollar has largely been a "commodity currency" this has contributed to keeping it at elevated levels and therefore hurting our manufacturing, tourism, and export sectors

- Global financial markets are "very accommodative" with cheap fund conditions as risk spreads have narrowed and equity markets have performed well since the middle of last year. However, "financial markets remain vulnerable to setbacks"…so volatility may be expected by the Reserve Bank.

Inflation is off the agenda

- The Reserve Bank's view is that inflation is "likely to be consistent with the target…over the next one to two years". It is currently 2.25%

- "Labour costs remain contained and businesses are focusing on lifting efficiency"…so businesses are looking to increase productivity or "getting more from less".

So if the Reserve Bank is unconcerned about inflation, its certainly concerned about economic strength which is measured by Gross Domestic Product (GDP). At the risk of being overly technical, GDP is measure by adding the income generated from Investment (I), Consumption (C), Government Spending (G), and Exports minus Imports (X – M); i.e. GDP = I + C + G + (X – M)…so what did the Reserve Bank say about each component…

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What did the Reserve Bank say? continued…

(I) Investment is uncertain…

- Resources capital spending drove 2012 growth, but "the peak in resource investment is drawing close".
- "The near term outlook for investment outside the resources sector is relatively subdued, a modest increase is likely to begin over the next year"…but unfortunately there is no indication of what
- "Dwelling investment is slowly increasing"…although just a matter of days after the Reserve Bank's statement, the Housing Industry Association announced that "New home sales had tumbled" by 5.3% in the month of February. So the key word is perhaps "slowly"!

(C) "Consumption experiencing moderate growth"

- "…though a return to the very strong growth of some years ago is unlikely", and
- "The demand for credit has also remained low thus far, as some households and firms continue to seek lower debt levels"…higher savings means less spending

(G) "Public spending is forecast to be constrained"

- Economic growth or no economic growth, it is clear the government is focused on spending cuts and minimising their budget deficit…contrasting the work of the independent Reserve Bank!

(X) "Exports of natural resources strengthening"…but…

- …moving forward a high Australian dollar does not help this. Plus, when you consider the massive depreciation of the Japanese Yen in Australian dollars, the terms of trade with our second largest trading partner is also looking weak which doesn't augur well for future growth…so…

(M) …High Australian dollar to increase imports

- "The exchange rate, which has risen recently, remains higher than expected", and Australia's increasing use of overseas shopping over the internet is likely to continue.

So, the Reserve Bank's comments around the components of GDP weren't exactly glowing and they acknowledged that by saying, "growth is likely to be a little below trend over the coming year". They also acknowledged there is scope to "ease policy further, should that be necessary to support demand".

Whilst many might argue the above interpretation of the Reserve Bank statement is overly dovish, it's difficult to disagree that interest rates are highly unlikely to significantly increase in the coming months and that there are more downside risks to the economy then upside. As a result, the Reserve Bank statement is further evidence supporting last month's conclusion that interest rates will be at or near current levels for some time yet.

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Europe Situation

The European situation is an ongoing saga and the problems continue to get worse and worse. In brief, some of the latest includes…

- Euro area unemployment hits record high at over 12%.
    - Spain and Greece's unemployment rates at 26.3% and 26.4% respectively, they are trending in the wrong direction and can only mean social unrest, lower government revenues, and without their own currency to depreciate, continued depression for many years.
- Italian government still not formed…
    - Berlusconi still a chance returning as Prime Minister…sharemarkets may not be happy with this; perhaps local bond markets may be the safe haven beneficiary
- Cyprus banking collapse bailed out by depositors holding more than 100,000 Euro.
    - So now a Cypriot Euro is worth less than all other Euros
    - This is a new solution that will pressure smaller banks in other parts of the Euro zone…particular in "at risk" countries like Spain, Portugal, Ireland, Greece.
    - Who is next? Luxembourg's banking system, like Cyprus's, is many times larger than their GDP and therefore places the nation as a whole at risk.
- Portugal is starting to hit the news again…
    - The government's plan on suspending monthly salary payments to its state workers and pensioners has been overruled by the courts…so the government intends to implement spending cuts elsewhere so they can continue talks on extending maturities on its loans. A government collapse and default is possible!
    - Austerity in a depressed economy such as Portugal's is bound to lead to more economic troubles so going from bad to worse is inevitable and the next Euro-related disaster could be Portuguese debt default talk again…this could be bad for risky assets like shares but good for highly rated bond markets like Australia.

…and some Japan

At the end of last year Japan voted Shinzo Abe back into office as Prime Minister and not long after he announced his intention to undertake massive monetary and fiscal expansion and target 2% inflation in order to get Japan out of its deflationary rut.

On Thursday 4 April, Abe announced a massive round of quantitative easing (money printing) including mass purchases of Japanese Government Bonds (JGBs) as well as Real Estate Investment Trusts (J-REITs) amongst others.

The result has been a strong decline in the Yen against all major currencies (including Australian dollar) and the Japanese sharemarket index, Nikkei 225, increased from around 12,000 on April 2 to over 13,000 at the time of writing (April 8). For the Japanese economy, both are good results but its obviously early days. This Keynesian approach is the complete opposite of the austerity approach in Europe and many prominent economists believe this approach is Japan's best chance yet to reinvigorate its economy.

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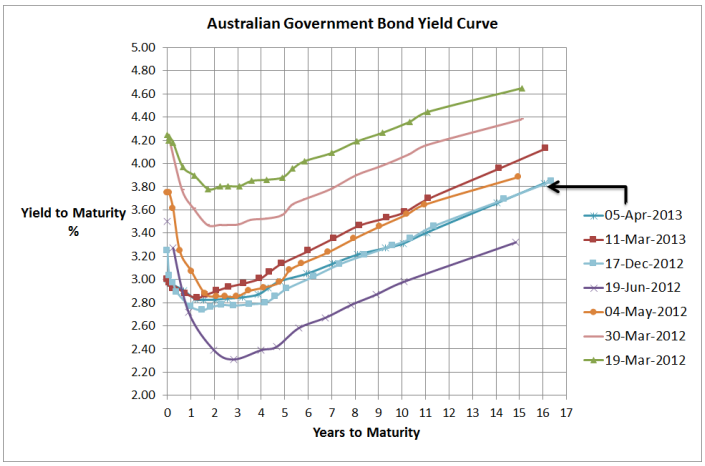
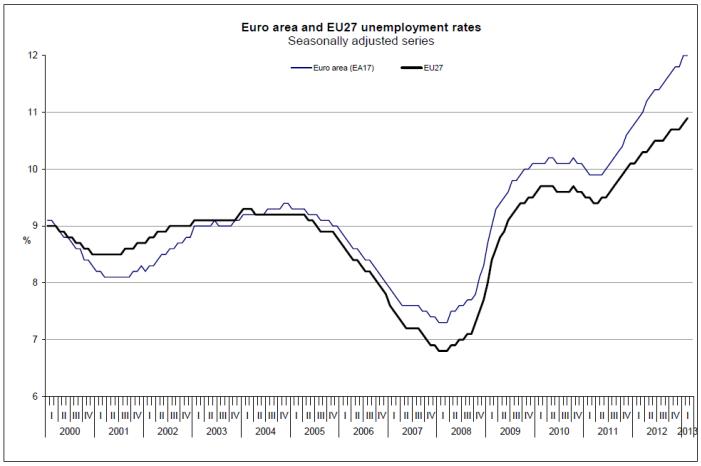
A recent small reduction in Australian Government Bond Yields

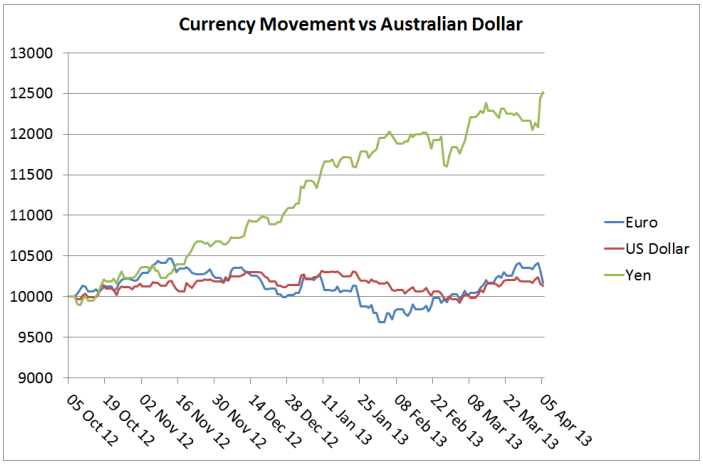


Europe's Record Unemployment



Source: Eurostat

Australian Dollar's Appreciation against the Japanese Yen



Source: Morningstar Direct

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