RIMsec
Fixed Income Specialists

# AUGUST RESEARCH

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## Current Themes

- Following Ben Bernanke softening on his May statement of a pullback on the US Federal Reserve's quantitative easing program (QE3), most markets have steadied over the last month and the increase in longer term bonds have stabilised. The previous themes of investors seeking higher yields from risky assets continues.

- In Australia, the Reserve Bank reduced its cash rate to a record low 2.5% due to a slowing Australian economy and lower inflation environment. This will provide further support to interest rate sensitive sectors such as housing, although weak labour conditions in Australia may ensure property prices don't increase too quickly. Whilst the weak labour market should dampen inflation, importing higher inflation due to the significantly weaker Australian dollar will ensure it stays within the Reserve Bank's target range of 2% to 3%.

### Interest Rates

- Whilst the Reserve Bank has reduced its cash rate to a record low 2.5%, the bond markets are still pricing in another 25bps reduction by the end of the year. As mentioned above, a weaker Australian economy is the primary issue the Reserve Bank is addressing and whilst inflation is low there is scope for further reductions if required.

### Credit Spreads

- Since credit spreads widened slightly during May and June (coinciding with sharemarket volatility), they have slightly narrowed as the chase for yield resumes. Spreads are still much wider than during the pre-GFC years so there is still scope for further tightening.

### Australian Dollar

- The Australian dollar has stabilised and has traded around $0.90USD over the past month. This is still higher than the Reserve Bank would like but this lower level is still around 15% lower than earlier 2013 highs so in time it should have a positive economic effect by improving the relationship between funds flowing in and out of the country.

### Volatility

- Whilst volatility has calmed somewhat, similar to last month…Bernanke's statements over May and June showed how jumpy the sharemarkets are about what he is doing and the extreme monetary and fiscal policy position in Japan could mean that higher sharemarket volatility becomes the norm. Avoid complacency to volatility.

## Macroeconomic Risks

Global macroeconomic risks remain quite significant to Australia with the driving force of the Australian economy over recent years, China, producing good growth but at an increasingly slower rate thereby placing downward pressure on our growth potential. Growth in most of Australia's major Asian trading partners have recently had their growth outlook revised down although according to the Reserve Bank it is expected to pick up in 2014.

In contrast, Australia's second largest trading partner, Japan, produced "rapid economic growth" in the March quarter aided by its expansionary fiscal and monetary policies and depreciated currency. Europe has just produced a weak, but at least positive economic growth result for the June quarter, which technically stops an 18 month recession, and the US continues its slow recovery.

In Australia uncertainty around what will drive economic growth into the future continues, as growth contributions from mining investment will significantly decline in the latter half of 2013. On a positive note, there is a possibility that business confidence may increase following the September 7 election as future government policy is unknown until the election result is known. Either way, lower interest rates and currency provide support for the Australian economy even if a focus on budget surplus by both sides of government is not.

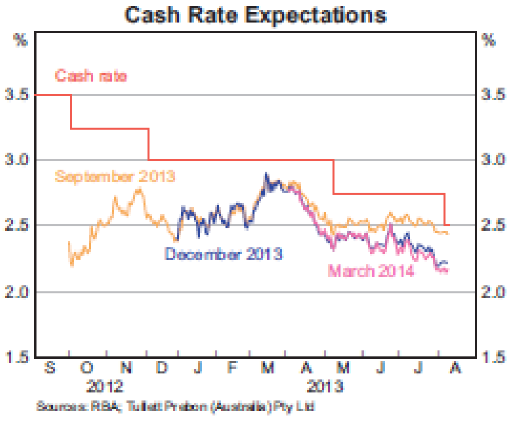
## Interest Rates…how low will they go?

On 6 August, Glenn Stevens announced that the Reserve Bank is reducing its cash rate to a record low 2.50%. This is 0.50% lower than the lowest level during the Global Financial Crisis and therefore quite indicative of future concerns for Australia's economic growth.

Glenn Stevens' monetary policy statement produced nothing too different from the July statement except acknowledging that lower rates are helping the housing market from increased demand in finance by households. With an outlook of higher unemployment, there is always the concern that too much debt can become a significant problem in the future so the Reserve Bank will undoubtedly be keeping an eye on these statistics moving forward.

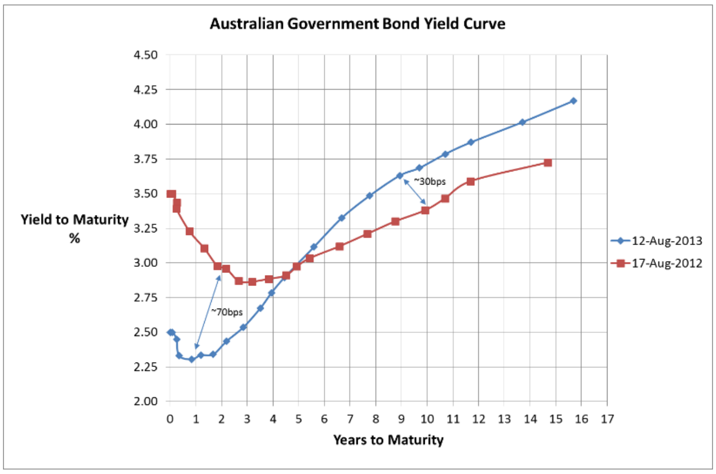
Whilst interest rates are at record low, bond markets are suggesting that it is unlikely to be the Reserve Bank's last move. December 2013 and March 2014 Overnight Index Swap rates are trading around 2.25% (see Chart 1) and December 2013 Government Bonds trading around 2.3%, all suggesting the likelihood of another 25bps reduction before the end of the year.

### Chart 1 – Cash Rate Expectations




Source: Statement on Monetary Policy – August 2013, Reserve Bank of Australia

## Chart 2 - Australian Government Interest Rates



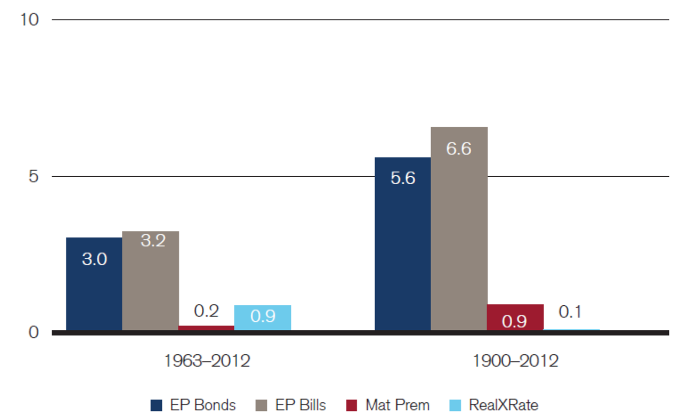

Source: Reserve Bank, Delta Research & Advisory

In terms of the longer term interest rates there has been a significant increase over the last 12 months as shown in Chart 2. Over the last 12 months interest rates have increased for terms greater than 4.5 years whilst decreasing for terms less than 4.5 years. So what might this mean?

This twisting of the yield curve may have many meanings depending on who you ask, but the steepening may be interpreted as market confirmation that the Reserve Bank strategy of reducing interest rates is the right one. In other words lower rates are required to provide stronger economic growth into the future and this is reflected by the higher interest rates at the long terms to maturity. As we know, as soon as any economy starts to look like producing anything resembling strong growth, the central bank will increase rates to ensure inflation doesn't get out of hand therefore a higher yield is required for longer terms.

## Chart 3 – Australian Sharemarket Risk Premiums

**Annualized equity, bond, and currency premia (%)**




Note: EP Bonds denotes the equity premium relative to long-term government bonds; EP Bills denotes the equity premium relative to Treasury bills; Mat Prem denotes the maturity premium for government bond returns relative to bill returns; and RealXRate denotes the real (inflation adjusted) change in the exchange rate against the US dollar.

Source: Elroy Dimson, Paul Marsh, and Mike Staunton, Credit Suisse Global Investment Returns Sourcebook 2013.

Source: Credit Suisse Global Investment Returns Sourcebook, 2013

There is another reason as to why the longer term interest rates have increased and it has been playing out all around the world across all markets from the USA to Europe, to Emerging Markets. It is simply the flow of funds from long term bonds to short term bonds and cash. The most significant move away from long term bonds around the world coincided with Ben Bernanke indicating a tapering of QE3 so this announcement has possibly resulted in a reduction of the “carry trade”. A “carry trade” is where an investor borrows at low interest rates to buy higher yielding assets (such as longer term bonds).

On the shorter term to maturity part of the yield curve in Chart 2, yields are below the current cash rate indicating the market’s expectation of even lower interest rates from the Reserve Bank. The fact that they are below 2.5% out to over 2 years indicates the market expects the Reserve Bank to not only reduce rates but to keep them lower for this period of time. This is a clear reflection of the uncertainty surrounding the Australian economy (and the global economy which continues to splutter along) and its upcoming slowdown from lower levels of mining investment.

The final observation from Chart 2 is the fact that 10 year bonds are currently paying around 1.25% more than the cash rate (and even more than 1 or 2 year bonds) and this is quite significant. Chart 3 shows that over the last 50 years the riskier Australian sharemarket has only returned 3.2% over the bond market so perhaps the riskier end of the bond market (i.e. longer duration or longer term to maturity) is offering premiums that may be attractive again in this apparent lower inflationary environment…of course, the reverse may be true if inflation unexpectedly appears but for the moment the longer term to maturity is more appealing than it has been for some time.

Designing an appropriate investment strategy for today is far from easy. It is a low interest rate environment that is likely to be low for some time meaning that lower return expectations are essential. This in turn is likely to lead to the increased possibility of overvalued risky assets from time to time as investors chase higher returns away from conservative investments. Whilst for many increasing risk may be necessary to meet their needs, if an investment goal is short term or is to simply outpace inflation, accepting too much risk to do so is fraught with danger as valuations become distorted and the possibility of artificial/government stimulus is unwound and market uncertainty comes to the fore.

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