

→ Income & Fixed Interest Newsletter

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October saw a continuation of the bond rally that was started by September's FOMC meeting. US ten-year treasury yields are now 50bp off their September highs but still about 100bp above their May lows. Given all the hype about the size and ferociousness of the bond bear market it's interesting to note that the Australian Government index has returned +0.92% for the calendar year to date, the composite index has returned +1.55% while in the US (in local currency returns) the Treasury index is only -1.54%, while the US aggregate index is -1.12%. While these returns don't look anywhere near as scary as people had feared they pale in significance when compared to the equity market performance with the S&P hitting numerous all-time highs in October and closing the month at 1,756, up massively from the March 2009 low of 666.

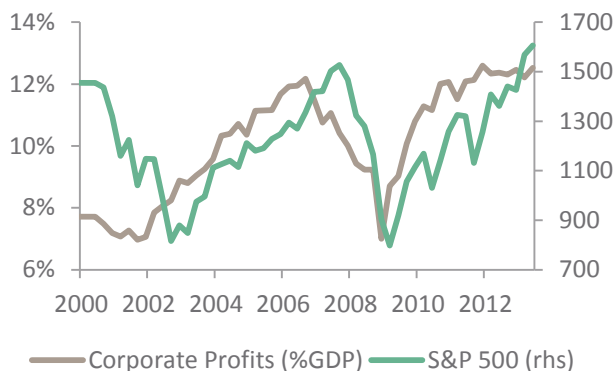
The Fed obviously finds itself in a difficult situation: it has highlighted its concerns about the efficacy of QE and the asset bubbles it fears it is inflating but the market performance in May and June shows how difficult it is to stop the monetary heroin. Even the hint that the taps might be turned down caused a massive market dislocation which saw bond yields rise materially largely negating the \$3.8 trillion of buying the Fed has conducted. Even more worrying was the ripple effects we saw in all markets as credit, equities and commodities suffered, particularly in the highly leveraged emerging markets. But the continuous buying the Fed and other central banks are

undertaking is grotesquely distorting asset markets and driving a clear wedge between the asset markets and the underlying economic fundamentals. Given the sober economic backdrop it could be years before QE is eventually finished and these links are re-established, though it is highly likely that the bonds are never sold and are just cancelled by the Fed. Given this backdrop we had a quiet month on the funds and returns were around index across most of our key flagship products.

I took the opportunity in [last month's newsletter](#) to look at the longer-term valuations for a number of asset classes, and we saw for bonds and equities the story was clear in that both seemed to be at valuation levels where forward looking returns aren't particularly good. Trying to forecast asset class returns in the short term is always more difficult as there are always plenty of charts you can use to make a strong case that share market returns either should be coming under pressure or heading to the moon. Right now a favourite for the bears is putting the corporate profit share of GDP (which is at historical highs) up against the share market and then screaming out "it has to turn!", but for every one of these charts there are explanations for why we are at these levels, and in this case it may be that corporate profitability is temporarily high because of the lack of business investment, and the amount of buybacks going on with that unused capital instead. The longer-term valuation models remove this shorter-term volatility by

concentrating on current valuation levels, which can be a blessing and a curse.

Chart 1: Corporate Profits & the US Equity Market



Source: Bloomberg

The perceived richness of both equities and bonds at this point in time plays straight into something else that we've been talking about: the varying relationship between risky and risk-free assets away from their usual negative correlation. Interestingly, while this negative correlation has dominated most of our careers, it actually hasn't been applicable through most of history. This phenomenon can largely be explained by two catalysts (which are interconnected in their own right) – the retreat of event dominated risk and the proliferation of quantitative easing as a tool to fight low growth and deflationary pressures the world over – and I would argue these have been effective in driving down volatility and enabling the portfolio reallocation effect by forcing investors out of low yielding, low risk assets into higher risk assets like equities. This effect can be self-perpetuating because a rising equity market will have an effect on confidence which spurs real economic activity and speculation in other asset types like housing or emerging markets.

The volume of bond buying by central banks and a general lack of bad events from the usual suspects (Europe mostly) has meant that equities have had a stellar 12 months, with the US S&P 500 up nearly 25%. Let's not forget this occurred against the backdrop of a year

when the significant fiscal drag in the US threatened growth and another debt ceiling debacle was only around the corner. For the most part the rise was supported by good corporate profits, and later in the year half decent economic data also helped to give an extra boost. So generally it's been a good news story even though the debt ceiling debacle tried its hardest to derail the situation. While employment growth isn't stellar and the growth path of the economy hasn't really recovered, the fiscal drag of the debt deal from late last year is rolling off and the housing market is looking like it may be able to withstand the higher rates and add to economic growth in the next year. I have spoken about these two effects at length earlier in the year and I don't think the outlook for these catalysts has really changed. The only thing I've revised in our interpretation is where the appropriate hurdle rate for the Fed is for growth and employment. With the benefit of hindsight it's clear the hurdles are lower than we had originally thought but the level of stimulus they are providing to the economy is also unmatched so it would make sense that the hurdle for removing at least some of that liquidity is not as high.

Chart 2: US 30 Year Mortgage Rate

Source: Bloomberg



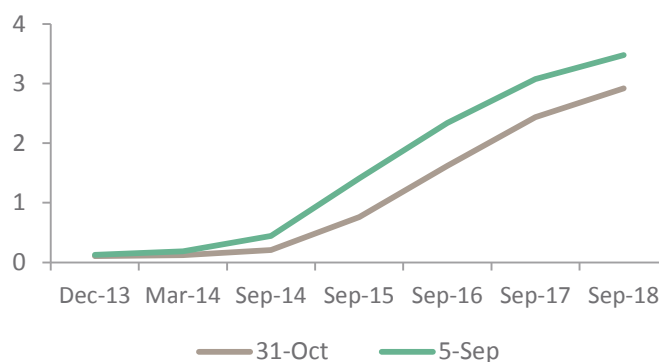
However, within this context at first glance it was tough to understand what the Fed was doing when it bucked the market consensus and decided not to start tapering its Quantitative Easing program. They certainly went to an extraordinary effort to introduce the plan in the months leading up to the market-changing June FOMC meeting. Why go through the trouble of introducing such an idea

if they weren't looking to follow through? After market participants went through the pain of June (and a lot of people were caught badly offside – find a Macro Hedge Fund survey and take a look at the results for that month) were the Fed just trying to punish them again? The reality of the situation is that this is true to a point. Punishment goes hand-in-hand with managing expectations. Market participants had had it too good for too long leading up to June, and a large part of that success was due to the Fed's largesse. The Fed knew this was the case (as we spoke about in the [June newsletter](#)): equity, credit (especially high yield) and emerging market (EM) debt markets had an excellent year up to that point, and there were clearly fears that asset bubbles were being stoked. This one-way price action, coupled with the numerous central banks puts (Bernanke, Draghi, etc) made it an easy bet for risk-loving funds.

The returns for these funds leading up until June do the explaining for themselves. According to [HedgeFundIntelligence.com](#) until May 2013 EM debt funds averaged nearly 8%, EM equity funds averaged nearly 16%, developed market equities over 12% and macro hedge funds just under 5%. Strong numbers for sure but they also highlight the amount of correlation between returns at that time. Since the end of May however the returns haven't been crash hot at all. Emerging market equity and debt and macro are down, with equities the only positive result at +3%, presumably because they were still long. When the Fed decided to adjust its reaction function it was always going to be painful. Once the market had become comfortable with the change in this reaction function, that one-way bet really just switched sides. Where it was buying before, it became selling. In bonds the forward curve was pricing in a very aggressive Fed post-tapering (which was forecast to end by mid-2014). The Eurodollar curve had the Fed's first hike in by late 2014, rising to 3% by 2018. There is nothing wrong with this forecast of course, it may turn out to be entirely correct, we just don't know yet. The problem is that this trade

would have got a whole heap more traction if the Fed went ahead with the plan to slow purchases under the Quantitative Easing program.

Chart 3: Federal Reserve: What's Priced In



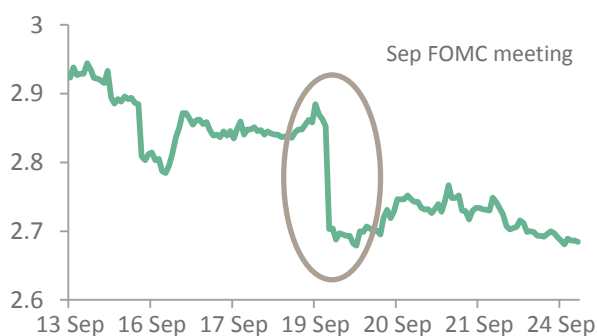
Source: Bloomberg

This might seem counter-intuitive. A result in-line with market consensus should mean the market doesn't move. This may be going a little too deep into the realm of behavioural finance (or more so statistics) but the skew and the variance of the markets view is also really important. Just like the average result of a batsman's innings tells you nothing about how many ducks he has conceded, a 'market consensus' for how much the Fed was going to taper in September (which is very hard to measure anyhow) doesn't reveal how much of the market is expecting a lesser amount of tapering, or none at all. The other problem here is that the question of 'how much is the Fed going to taper' isn't just limited to how much they were going to do in September. The whole idea of tapering is not a plan that plays out over one month but over the next year or more. Even if a market consensus result for the amount of tapering in September was achieved, those market participants that had no taper in or a slower timeline for tapering would react and push the market.

Market moves from June were still fresh in every trader's mind and this means they would be much more inclined to sell a market that was moving sharply, chasing yields higher. In the context of the massive sell-off we saw in

May and June the fact the ten-year yield rallied by only 20bp after the hugely surprising FOMC announcement shows us the market consensus was actually nowhere near what everyone thought. After all of this the Fed has actually succeeded in what we think they were trying to do, which was to engineer a tapering plan that wouldn't result in rising yields choking an economy still trying to achieve an acceptable growth rate. This is entirely in-line with our own analysis as any more of a sell-off would have subjected the economy to a rate that was way higher than would have been the case over the last ten years once current inflation and growth was taken into account.

Chart 4: US 10 Year Yield Intraday

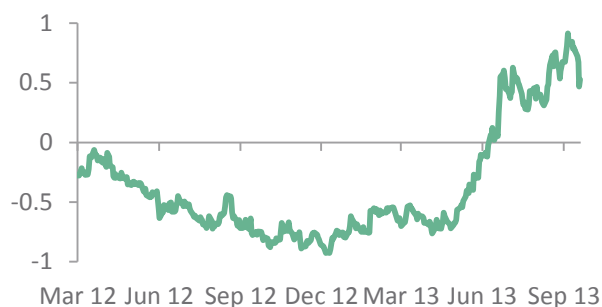


Source: Bloomberg

So the Fed's spin on its communication was successful as we think it was acutely aware of the threat of yields running away to the upside. The US ten-year Treasury yield moved above 3% for the first time in two years. Back then headline inflation was running at a rate over three times the current rate (3.9% in September 2011 against a rate of only 1.2% for September this year) which would justify a higher rate for the ten-year bond at that time. The US ten-year inflation protected Treasury bond recovered from a deeply negative yield to get close to 1%, a round trip of nearly 2% in less than a year. While the absolute levels aren't eye-popping, anything more and an encouraging recovery in housing would suddenly be stunted and a fast path of tapering would end up needing to be reversed by late next year. The tightness of financial conditions was removed from last month's statement, after the fall in yields indicating that a more

comfortable level for US Treasuries had been found. This means the Fed clearly wants to avoid a situation where financial conditions are too tight, so tapering has to be rolled out in such a way that it doesn't affect bond market pricing. Right now a yield range for 10-year US Treasuries of around 2.5% to 3% sounds about right, both from the timing of Fed announcements and our own estimates.

Chart 5: US 10 Year TIPS Yield



Source: Bloomberg

Chart 6: US 10 Year Yield



Source: Bloomberg

In the short term the Fed has engineered a level of financial conditions that it is comfortable with by delaying tapering to an undefined future time. They obviously can't do this forever because eventually it will get to a point where they have to deliver or, as any central banker would tell you, the resulting loss of credibility would create an unthinkable situation that (god forbid) turns markets into the Wild West.

When the Fed finally and inevitably enacts tapering, the initial amount will likely be a lot smaller than anyone expects. This will send the signal that 'yes, we are starting this', but at levels so insignificant that the market won't

panic because the liquidity hit hasn't been taken away just yet.

It's been especially tough trying to rationalise the changing correlations between different assets over the last year – not only do traders have to factor in these almost impossibly different goals of the Fed, the most important central bank in the world, but they have to simultaneously juggle these with correlations that have been damaged under the weight of QE. Alternatively the question we can ask is: if we have a high conviction view on one asset (say bonds for example) what does that mean for other assets like the US dollar or equities? The answer to this question is so incredibly important because getting it right can mean the difference between a well-diversified portfolio and one with just one big trade on in ten different markets.

When judging correlation near-term experience is always a big factor along with longer-term norms. For about the last 20 years, bond and equities have enjoyed quite a strong negative correlation. A negative correlation between bonds and equities has a fairly good theoretical backing in that falling equities usually means rising risk/slowing economy and central banks have reacted accordingly and cut rates, profiting bonds. This works perfectly fine when we are not at the lower bound for rates and inflation is well contained and stable. Prior to this 20-year period however, swinging inflation (deflation in the 30s, inflation in the 70s) made the link a lot less reliable.

While QE has scared a lot of people into believing there will be inflation in the future through unbridled money printing, the reality is it only managed to move real yields while leaving inflation untouched. Depressed real yields have created a similar situation to fluctuating inflation prior to our current era of calm and negative correlation. Looking at shorter periods during the last year correlations have varied wildly, especially around the dates that the Fed made their key communications.

Chart 7: Bond Yield vs Equity



Source: Bloomberg

The shaded areas in the chart show when strong positive correlation (in prices, the chart above shows yields) existed on a daily basis. If we compare this to a year before the GFC the difference is like night and day. This can be chalked up to the effect of the real yields manipulator changing the way it's manipulating. You may have noticed though that over the year equities are up and bonds are down, restoring the natural order. The fact that longer-term correlations have remained steady is promising for longer-term asset allocations (i.e. your portfolios) but has made running a diversified book of trades difficult. The longer-term correlation is still holding because of stable inflation, but the shorter-term breakdown in correlation has made it very hard to manage a diversified book of trades.

If economic data remains as good as it has been recently then we can be fairly that the Fed will want to taper sometime soon, because of the perceived negative effects of QE. It will need to handle this communication well enough to avoid spooking the market to sell off bonds too far and derail the recovery but simultaneously it will need to not underwhelm too so much as to get real yields falling too far to stoke more bubbles in assets like credit and emerging markets. Designing a communication policy to simultaneously achieve these things sounds like a nightmare and it probably is. It's the reason that the Fed is also going to appear like it has no idea what

it is doing when it communicates its intentions to the market. It will seem to be contradicting itself when it is just trying to achieve the impossible. The only thing that we see persisting into the future is this varying correlation. At a time when the Fed doesn't handle its communication well (and it's so complicated there is a good chance they won't) then we'll be back to equities down, bonds down, credit down and emerging markets down. Maintaining a diversified portfolio may seem tough in this environment, but it's still a lot better than holding low yielding cash.



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