→ Income & Fixed Interest Newsletter

Vimal Gor

There can be no doubt that Trump's victory will be game changing geopolitically as it will alter the course of established diplomacy. Trump's policies have also sparked calls for the end of the possible end of 30 year bull market in bonds as it is bringing our theme of fiscal policy taking over from monetary policy to fruition. Increasing fiscal deficits, increased debt issuance, a terming out of debt, rising wages, rising breakeven-inflation and falling output gaps all add to the bearish backdrop for bonds and bond proxies. At least you can sell government bonds here (as we have done) as they are very liquid. The main losers from this shift are the recent buyers of super-long Italian 50 year bond issuance in early October, bought at eye-wateringly low yields, as they will be accruing out of those losses over a very long time (if they don't default before that). We had a small down-month on the flagship funds; these were caused by our structural long bond positions, a large degree of which were unwound over the month.

While we have serious reservations about how high bond yields can go and how sustainable these higher yields are given the gargantuan debt load the world carries. Therefore we have closed a large proportion of our long-held structural long duration positions and reduced the size of the portfolio materially. In this newsletter I look to set out the medium-term view and highlight a number of the potential problems.

It will be a bumpy ride either way as bond bear markets are much more volatile than bull markets as short positions are negative carry to run and turnarounds in positioning can happen very quickly. The other complicating factor is that as US bond yields rise they make other assets more vulnerable to a sell-off, which introduces a self-correcting mechanism to yield selloffs, and these factors include; a higher discount factor, slowing economy, stronger currency, overseas earnings translation effect, tightening credit conditions, etc etc. We have

long wished for the return of volatility and it is finally arrived, I couldn't be happier about the opportunity set going forward.

So Donald Trump may or may not make America great again yet, but he has set off a chain of events that have certainly made global macro trading great again. He has injected well needed volatility into a market that was suffering from the same sclerosis that the Hillary Clinton and the established 'elite' were offering an embattled middle America. The day played out in volatile fashion: the risk-off trade (equities sharply off and bonds rallying) took hold after it became apparent that he would convert long held blue states into red states, losing the popular vote while claiming enough electoral college votes to become the 45th President of the United States. This risk-off only lasted for a few hours until the market was gripped by the same hope he is offering those hardest done by to the trends of globalisation. Hope that there is a chance out of a world with low and falling growth, low and falling inflation and central bank manipulation through Quantitative Easing and zero rates. A world where reform and fiscal stimulus is a possibility as the Republican party rules the White House, the house and the senate. While Trump's relationship with the Republican party is not what you would consider rosy, the potential is incredible and the market has caught the ball and run hard with it.

This has seen the largest monthly selloff in US Treasuries since January 2009, and US 10yr yields have jumped higher by roughly 55 basis points (bps), with bonds across the world following. From the lows in early September, Australian 10yr bonds have now risen about 90bp, a very significant move. Equities responded very well and reached new highs in the US, after dumping more than 5% in immediately post the result. The US Dollar has been the standout performer though, rising 8% against developed and 7% against emerging market currencies. The epicentre was USDJPY which rose 10%, reversing half of the move downwards since early 2016 in just a few weeks. While the move in the Yen was large, it was mirrored by most EM Asian currencies, with most importantly the Chinese Yuan continuing its march higher both against the US Dollar and the PBOC's basket of currencies. Busting the usual 'US Dollar up, commodities down' correlation (which I have written about on numerous occasions throughout the extreme commodity bear market of 2014-15) was a strong rally in commodities led by base metals. Copper specifically has been particularly interesting not just due to the move over the last month (roughly 25% higher) but because it has broken a 5 year downtrend in prices that has been respected many times over that period.

Chart 1: The Trump effect has broken the multi-year down trend

Source: Bloomberg

Copper has for a long time been known as "Dr Copper" in reference to its price moving in advance of global growth, as it is a key industrial metal with many varying uses. This relationship has broken down on two levels though, with the absolute level of GDP and the quarter by quarter change in GDP growth deteriorating post-GFC (like a whole suite of once useful market and economic indicators). The longer-term trend is broadly the same, but you could argue that now Dr Copper is no more useful than Dr Oil, Dr Iron Ore and Dr Pork Belly as all were 'picking' growth trends of the last 5 years (i.e. down). The myth of Dr Copper is still pervasive however, and the recent break in trends are fruitfully explained by the expectation of some massive Trump fiscal stimulus that will remove the US from its declining trend growth swamp and rescue growth and inflation in the US.

The most often mentioned Trump policy initiatives to explain the huge moves markets have included:

1. The expectation of debt funded fiscal stimulus (mostly focussed in infrastructure investment);
2. The return of protectionism whether it be through a beautiful gold-plated wall, tariffs, declaration of China as a currency manipulator, etc;
3. The expectation of a deal with corporates to bring foreign held cash back at a lower tax rate, or an even better deal to take ownership in more new infrastructure;
4. Abolishment of regulations, especially in banking and finance.

With Republican control of all the levels of government, some of these policies will likely become enacted. Abolishment of regulations are by far the most likely of the bunch, with protectionist policies (especially tariffs or any direct head-to-head battle with China) the least

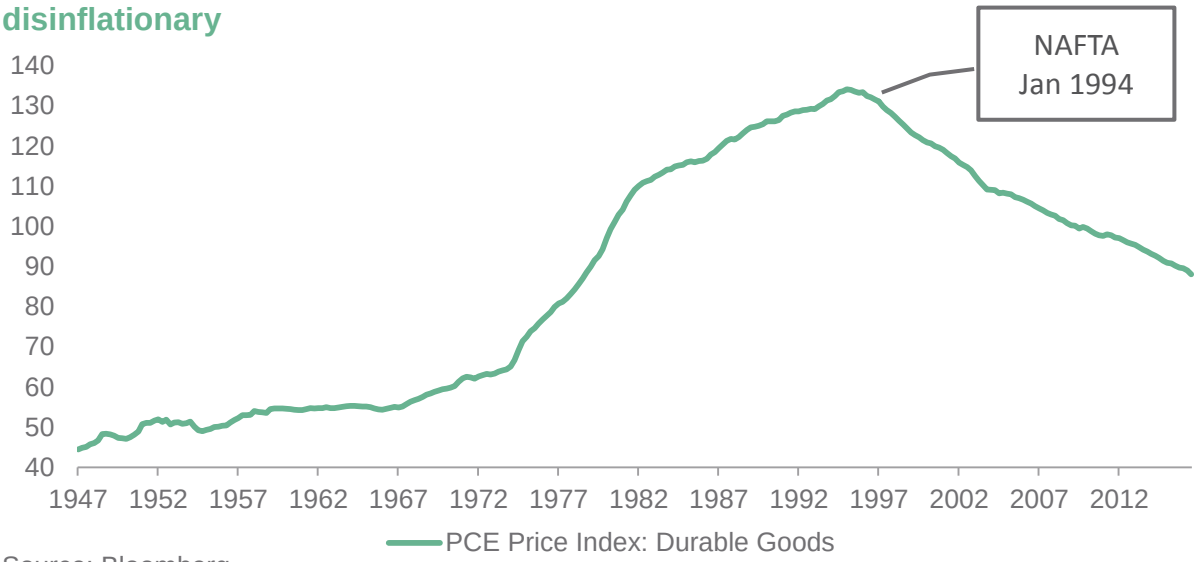
likely. The huge fiscal stimulus expected from Trump will likely be limited by the strong opposition to a further expansion of debt by Tea Party members in the Republican party, making this a difficult thing to pass. Repatriation of foreign held US Dollars through a tax deal with US corporates looks likely and this sort of reform is squarely in the domain of Trump's competency - deal making. Markets are forward looking, and the prospect of pro-growth and pro-inflation policy should cause long-end interest rates to rise, there is no doubt about that. However the strength of the move higher in yields looks too us to be too large once you weight the possible upside surprise in fiscal stimulus by the probability that anything actually happens, then discount the amount of time it would take to actually realise these changes, and then finally see the actual effect of it through the growth and inflation figures. A far more likely explanation for the move revolves around the market having a dummy-spit after being far too positioned for the "secular stagnation" theme, believing that QE infinity, flat curves and low yields were the short-term, medium-term and long-term view. This led to a market where there was almost no premium for risk, with the fixed income market being the worst example, especially in currencies such a Yen and the Euro.

It is very clear that Trump's policies will improve growth and inflation, but the key point is that these improvements will likely be pro-growth and pro-inflation in the US, but anti-growth and anti-inflation pretty much everywhere else. The main focus of the market, fiscal stimulus and infrastructure rebuilding, are proposed to be funded by an increase in the already large amount of government debt and through deductions on taxes on monies repatriated by corporates. The jump towards fiscal stimulus is a breath of fresh air after having lived through the painful life-crushing effects of austerity, especially in Europe, and represents a payoff to a market that's been looking for the shift towards fiscal stimulus as a new theme to drive pricing. There is almost an element of relief that we now have someone that is willing to try something else to get us out of our rut. Why slave away at continual austerity when in reality there is no chance of making any meaningful dent in the amount of debt outstanding? Rolling the dice by raising a whole lot of debt in the hope of that it will unlock a productivity miracle in the US seems like a far more palatable prospect after the stagnation that austerity has delivered. China's been doing it and things are looking up there more recently than they have so why shouldn't it work in the US? To be honest there are likely far higher chances of starting GDP accruing projects in the US given the lack of investment in this area than in China, but we won't know what these are for quite a while. So it is fair to say the potential for a growth upside is high, but the timing and magnitude are unknown.

Protectionism is another key theme running through Trump's policies, and this will almost certainly be inflationary if carried out in any significant size. Any limits on migrants will reduce the supply of cheap labour, while tariffs will raise the cost of imports and eventually their

domestic replacements and will therefore flow through to inflation. The most immediate effect would be the renegotiation of trade agreements like NAFTA, increasing friction from trade and lifting prices. Out of these protectionist policies renegotiation of these agreements is by far the most likely, given how obviously dead (ceased to be, expired and gone to meet 'is maker, stiff, bereft of life) the TPP is even before Trump has taken office. We can get an idea of the inflationary effects of backing out of trade agreements by seeing the deflationary effects of the introduction of NAFTA in the US.

Chart 2: While other trends were in place, trade agreements have been disinflationary



Source: Bloomberg

There are some other obvious effects of globalisation taking effect at this point as well, but all of these really do fit into the same bucket of globalisation versus protectionism, coincidentally a bucket that also contains the baby and the bathwater.

Mr Trump's first YouTube post as President-Elect stated that "for every one new regulation, two old regulations must be eliminated" (with a classic Trump "so important" uttered immediately after). This only served to reinforce the idea that Dodd-Frank would be repealed as directly referenced on the Trump transition website. This belief has seen the US Banks index up 23% since the election, with dedicated investment banks going up by even more. After personally being named and shamed during his election campaign the CEOs of big American investment are making out like 'bandits' (a deliberate choice of word) by the current situation, a fact that is probably not lost on the populist Trump supporter base.

Either way there is going to be a cheer and a fist pump from every investment banker that passes under the portrait of the President on the way into JFK airport customs from January onwards. Less regulation in banking and the environment (a very controversial topic which we'll address later) should be pro-growth, which can only be welcomed.

Chart 3: Less regulation helps markets

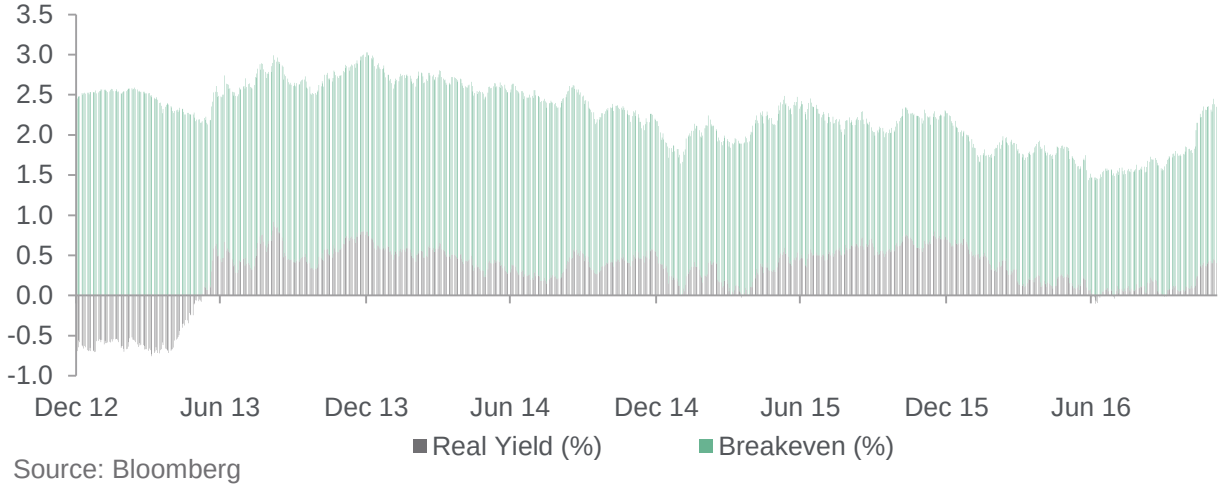
Source: Bloomberg

As there has been a big swing high on growth expectations then it should be no surprise that nominal bond yields are rising fast. The 55bp rise in the US 10yr yield is the biggest since January 2009 and just shy of the sell-off in 2004. While real yields led the sell-off in November (33bp of the 55bp has been real yield increase with the rest, of course, being inflation expectations), they have only picked up slightly from the extremely depressed levels we saw during most of 2016. In the US these real yields (as shown in chart 4 below) were roughly at zero. Real yields are an interesting concept to consider because they represent the return that investors are required to get (or the hurdle rate) excluding inflation on an asset with a certain risk profile. In a strongly growing economy where there are plenty of investment opportunities, real yields have to be higher to attract capital to those projects. As a result the real yields offered by Treasury bonds will be a function of this. A return to a high growth environment would have to see real yields climb to a level far higher than the average of the last 3 years.

This miniscule rise in real yields has also only happened since the election. The entire retracement in bond yields since the August lows has been a function of inflation breakevens, or the expected inflation as predicted by the nominal and inflation bond markets. This has continued to accelerate post-Trump, but the majority of the adjustment in inflation breakevens haven't really accommodated for the natural rise in inflation just adjusting for the fact that oil isn't falling like a stone anymore. In fact the forecast for US CPI next year is 2.3%, above levels we've seen since 2011. This still hasn't taken into account any actual reduction in output by OPEC (as unlikely as that is to happen). Yet inflation breakevens still remain stubbornly below these levels, leaving the inflation breakeven to inflation forecast spread at still very depressed levels. Secular stagnation is still very much a strong theme

running through the market despite the recent backup in yields, this shows how pervasive it was in August when the BoJ announced its yield curve control initiative.

Chart 4: Real yields up slightly, breakevens have led the way higher



Source: Bloomberg

If inflation breakevens continue to expand then nominal bond yields should keep on going higher. Another 30bp rise in nominal bond yields would get inflation breakevens back to levels seen in 2013, when inflation was last unaffected by falling oil prices. Even then the forecast for inflation in the US for 2017 is higher than what was expected from 2014 in 2013, meaning that there is even more potential upside to yields. Making a few more assumptions about wage growth, contraction of the output gap and so forth and 10yr yields could easily be back at 4%. What is the other side of the equation however? What are the forces stopping another huge lift in yields?

The answer to this question is one we have been talking about for years and it is the size of the debt load. To put it bluntly high interest rates won't work with the amount of debt that has been accumulated the world over, and that is a matter of mathematics rather than subjectivity. US government debt has increased $8.7trn since 2008 (more than doubled), and using CBO forecasts including the effect of Medicare, Medicaid and pensions, this could increase another 33% by 2020. But even though debt has been climbing at this rate the interest expense as a percentage of GDP has actually been falling because of the falling average cost of bonds on issue. Right now this average cost is around the 2.2% mark, having fallen significantly in recent years along with bond yields. Without adding in the Trump stimulus, the interest expense as a percentage of GDP before the crisis would be matched with a 10 year rate of 3.3% now (equivalent to 4% in 2020). While this gives a fair amount of headroom to current 10 year rates (roughly 2.4%), it must be remembered that trend GDP growth is far lower now than it was pre-crisis so that same interest expense as in 2008 is far more damaging to growth now. Nominal GDP growth was running at average

5.5% pre-crisis in the US, far higher than the 3.7% rate now. The capacity to pay interest has declined significantly so the upper limit in Treasury yields is even lower than 3.3%. Perhaps we are already there.

The 'chase for yield' theme that was so popular earlier this year really hasn't retreated either. The competition for assets is still rife, and is one of the reasons real yields are still held at such a low level as explained earlier. The flipside of an enormous amount of debt is that there is also an enormous amount of money that has been created and that still needs to find a home in a world where actual capital investment is still absent and financial assets are the only option. If we truly are still in a low inflation world (and we believe this until we get new information), then real yields will have to rise to let nominal bond yields rise substantially, and this will be met with buying as expected returns in bonds surpass higher risk assets given high real yields and very steep curves.

It hasn't just been the recent rise in bond yields that will have an economic effect either. The 8% rise in the US Dollar will have its own slowing effect on the economy, and the combination of these effects can be seen through the US financial conditions index which has a close relationship with GDP growth. The rise in the US dollar from mid-2014 to late 2015 significantly tightened financial conditions for the US, leading to growth falling from 4-5% (qrtly annualised) in mid-2014 to a low of just under 1% (qrtly annualised) in early 2016. So far we've only had a quarter of the tightening over that period, but this move will definitely cause the latest recovery in growth to evaporate as quickly as the easier financial conditions over 2016 helped create it. This will naturally cap bond yields as well as growth falls, with the natural ebb and flow of financial conditions likely returning long-dated bonds to their prior range.

Chart 5: Financial conditions tighter, growth likely to struggle again

Source: Bloomberg

The rise in the US Dollar, as during the huge US Dollar rally in 2014-15, encourages repatriation of capital back to the US shrinking the market for US Dollars for users of that currency outside of the US. These are predominantly EM countries who either have their currencies pegged to the US Dollar, or who borrow at the government or corporate level in US Dollars. These economies thrive when liquidity in US Dollars outside of the US is growing at good clip. Funding is cheap and capital is flowing into these countries and not out. Commodity producing countries also tend to be dependent on US Dollar flows for investment and funding, so the dual effect of commodities being priced in US Dollars and a retreat of capital from these countries have a double negative effect on the currency.

Trump's pre-election promise of convincing corporates to repatriate capital back to the US in return for lower taxation and other benefits is hugely promising for the US as this capital will find itself within US domiciled banks and expand the money supply inside the US, easing financial conditions. The cost of this benefit to the US is borne outside of the US though, where the reduction in offshore liquidity places strains of those economies most heavily reliant on the spigots of US Dollar liquidity remaining fully turned on. This causes repayment of US Dollar borrowing as borrowing costs increase, driving the US Dollar even higher. While EM (especially Asia) has been in a cyclical upswing because of the flood of credit Chinese banks have injected into the system over 2016, this is the circuit breaker that could trip this mini recovery up, and the effects will grow as we head into a very illiquid end of year. We are already seeing the first manifestations of this with Japanese cross-currency basis markets clearly pointing towards some severe tightness in the market for US Dollars.

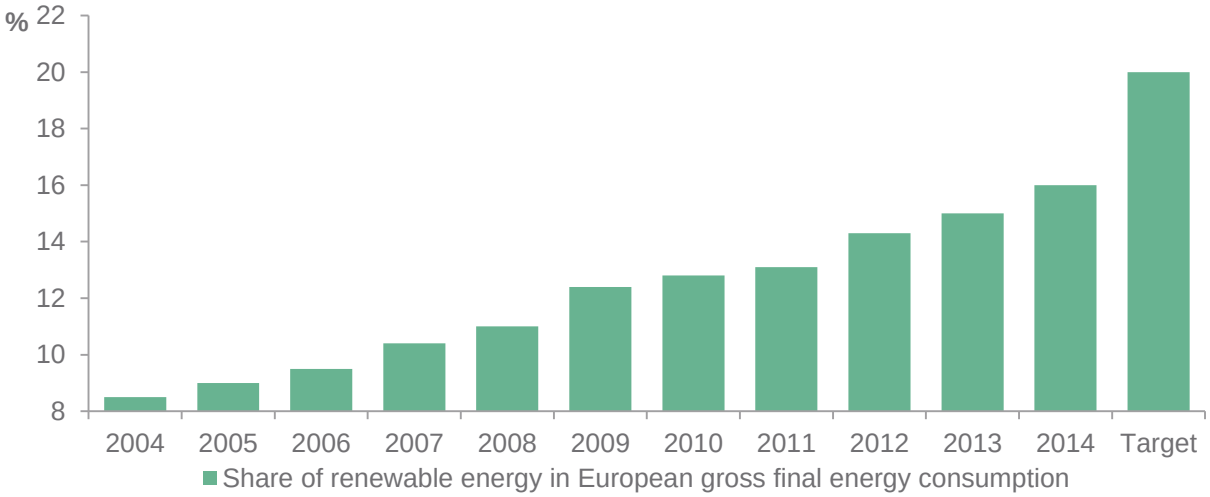
Chart 6: Tight Dollar markets are getting tighter

Source: Bloomberg

Moving on, one area which is likely the most controversial are Trumps policy regarding renewable energy. 'Clean' coal, the Keystone pipeline and a retreat from building newer

forms of renewable energy will clearly teleport those campaigning for a reduced carbon footprint back in time to about 1985. As painful as this might seem, the decision to go for cheap energy over clean energy will have immediate positive economic effects. Expensive clean energy decreases productivity in the economy as the money that goes into building and maintaining these expensive forms of energy means they have a low return on capital, essentially robbing this capital from another part of the economy where it could have been used in a more productive manner. Also that cheap energy may end up being used by someone else, providing the net benefits to another economy which isn't as predisposed to being environmentally friendly. The amount of capital ploughed into renewable energy projects in Europe could very well explain a lot of the underperformance of European GDP in more recent years.

Chart 7: Climbing renewables: better environment, worse economic growth?



Source: Eurostat

While this may seem extremely irresponsible to those that believe that we should be doing whatever possible to increase or chances of survival on this planet, what has been presented above is only one side of the equation. If climate problems end up costing far more in the future, then the loss of growth now will seem like a cheap cost versus what building a levy all the way around Australia in 100 years, for example. Alternatively if using renewables does nothing to avoid this outcome then we have sacrificed our way of life in the short-term for nothing. For Trump, making America great again will likely involve using that cheap energy before someone else does to gain any possible benefit from it, hence the push for 'clean' coal. Trump is clearly of the view that if someone else will cheat anyhow, what's the point in playing the game?

While the shock election result has revived a macro market that was obsessed with low rates, flatter curves and little to no risk premiums, the new President-Elect isn't and his policies aren't necessarily the clear cut upside to growth and inflation that they may look like on the packet. What they do offer is a shot at an upside in the future, even if only by mistake. This was something that HRC failed to offer voters that were sick and tired of the same policies that had delivered stagnant wage growth over the last 15 years through a slow transition from well-paying manufacturing jobs to low-paying service jobs. While the established elite may recoil at the thought that globalisation doesn't always deliver the best outcomes locally, the hope that a new tack will deliver upside has captured the market's imagination. While a disenfranchised American from the rust belt could possibly benefit from a move towards protectionism, a global investor is still playing in an environment that is essentially a zero-sum game so the ecstasy that the market finds itself in right now may prove to be short-lived.

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BT Investment Management's Income & Fixed Interest team of nine dedicated professionals, led by Vimal Gor, manage the #1 performing Australian composite bond fund of 2014 and 2011.

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