Higher US bond yields are at the heart of the repricing of all asset classes

November 2018

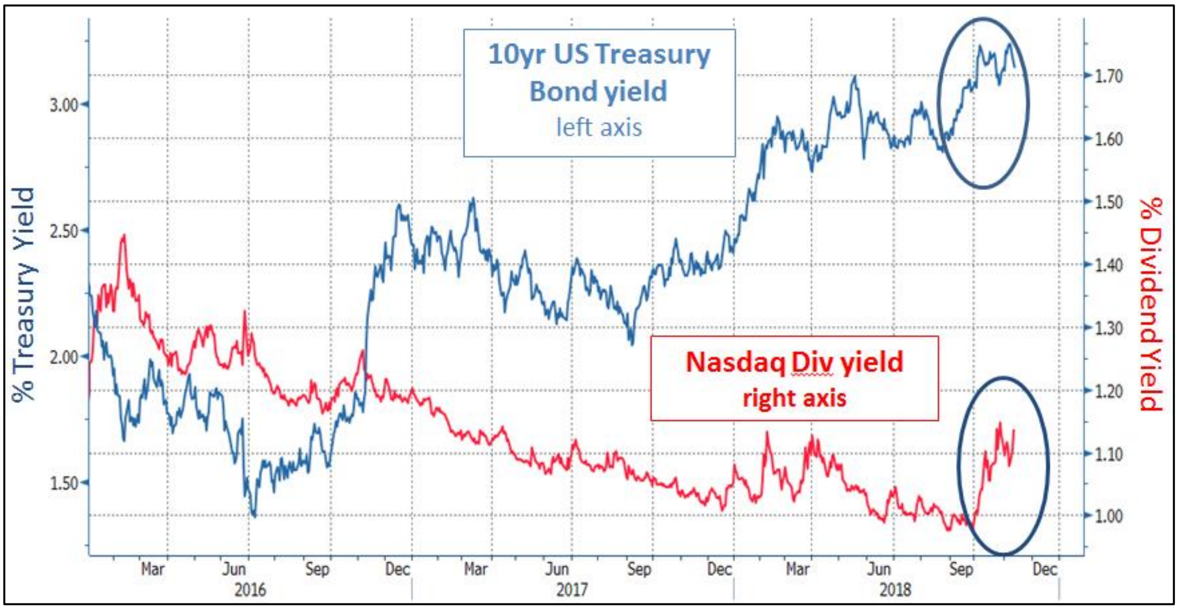
This is a peculiar part of the cycle. Central Bank bond purchase programs over the last seven years have dampened volatility and caused a strong correlation between bonds and equities. QE provided persistent support for the economy, as well as stocks and property, until such time it could stand on its own two feet. Nearly a decade on from the GFC the US certainly can. And so with US QE in reverse what remains is this; stocks adjusting to increasing yields associated with higher cash rates and the Fed reducing its bond holdings.

What we saw in October is part of an adjustment process that will be with us for some time. In the current time frame the US QE is in reverse and at some point in the distant future, the European Central Bank will do the same.

While this isn't an equity narrative the yield adjustment across asset class remains a central part of Altius's outlook. The impact is that the lift in yields (US included) will not be smooth and there will be rallies along the way. Our portfolio is positioned to take advantage of this shift to higher rates; more particularly the gradual rise of bond rates in Australia.

To illustrate the adjustment process, the yield on 10 year US Treasuries rose from 2.83 percent in late August to 3.22 percent in early October. It was at this point that stock yields began to adjust higher. The dividend yield on the Nasdaq lifted from 0.98 percent, the lowest in eight years, to 1.12 percent (Chart 1). It did this by adjusting prices down by over 14 percent (Chart 2). Over time, quality companies in a position to grow their earnings will take the adjustment process in their stride and their share prices will recover. However for companies that don't have earnings as a lever their yield adjustment will create share price declines.

Stock yields eventually had to adjust to higher yield of Sovereign yields



(Chart 1)

Nasdaq Index and Dividend Yield

(Chart 2)

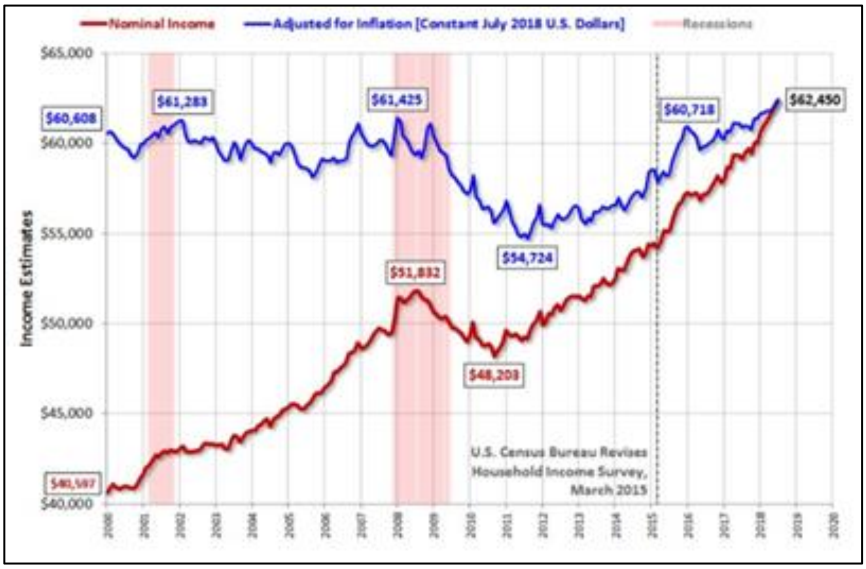
The significant fall in share prices saw investors progressively sell equities, particularly ETFs, and switch into safer assets. What did they buy instead? Some bought US treasuries others bought Australian and other bonds. Once the "excessive" part of the sell-off had settled, bonds resumed their path to higher yields and equities recovered (somewhat).

The adjustment also impacts emerging market and high yield corporate bonds (see "Major Asset Class Heat Map" below).

In Australia we are not looking for an uplift in default rates - but we think corporate bonds will feel the pressure of longer dated yields rising more than shorter dated bonds. It is for this reason we are focused on shorter dated holdings, where we can take advantage of the opportunities presented by the steepening yield curve while selectively buying high grade corporate bonds.

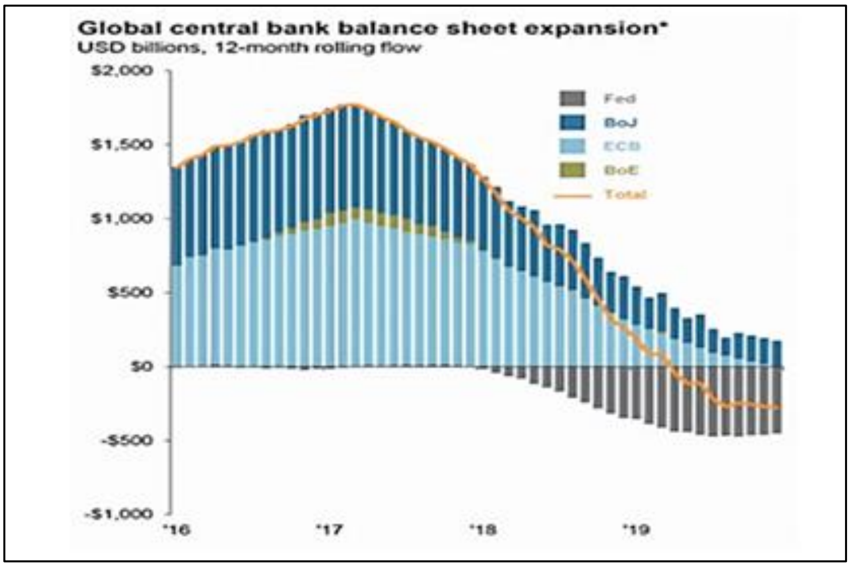
Why are bond yields lifting?
The strength of the US economy is well established. Wages growth in the US is a function of a tight labour market. The services sector is about 70 percent of the US economy. These are largely jobs that are driven by local factors, with scarcity of labour noted by most regions. US underemployment has fallen to 7.8 percent - a 20 year low. After adjusting for inflation, US median household incomes are nearly 10 percent higher than they were in 2014 (Chart 3). Core US inflation has shifted more consistently above the Fed's 2 percent target. Cash rates are consequently being lifted as inflation pressures build. Moreover, the Federal Reserve is now at maximum velocity in unwinding its balance sheet at $150 billion per quarter; inherently placing upward pressure on US bond yields (Chart 4).

US median household income.
Real and nominal



(Chart 3)

CB balance sheet. Unwinding underway. US first



(Chart 4)

Australia
That Australia's jobless rate has fallen to 5 percent is a remarkably good outcome, when you consider Australia's population has grown by about 16 percent over the last decade. Government sponsored infrastructure projects are contributing to economic growth. Tax receipts from businesses have been particularly strong. Underemployment, though, has lifted to 8.2 percent, with wages growing modestly as a result. After adjusting for inflation median household incomes show Australia largely at the same level it was in 2014 and core inflation is below the bottom end of the RBA's 2 percent target.

One area of concern unique to the Australian landscape is the possible consequences of the Hayne Financial Services Royal Commission. We are already seeing a tightening of credit standards. If bank customers are unable to demonstrate reliable sources of income, irrespective of the amount of assets, banks will not extend credit. The last thing they want to do – particularly in this environment – is foreclose.

Bank funding costs have already lifted, even though there has been no change to official cash rates.

This may incrementally slow the economy. Our view is that this supports the case for cash rates to remain unchanged into 2020.

Australian yields – higher but nothing like the US

There is a fear that US interest rates are set to explode higher, and take Australian interest rates with them. We believe US interest rates will move higher, but Australia has less pressure to follow in lock step. This is because European and Japanese investors search for higher yielding Australian bonds will remain while their Central Bank's keep buying the local bonds at ultra-low yields. Given the ECB is very slowly reducing their purchases of European bonds, their yields will slowly drift higher, allowing Australian yields higher at similar velocity.

Major Asset Class Heat Map
2018 – hunt for yield adjusts to higher risk free rates (Sovereign) & volatility

Short Name	YTD Total Return	% Return 2017	% Return 2016	% Return 2015	% Return 2014	% Return 2013	Period Total
Sovereign							
GA Treasuries	-2.63	7.29	1.65	-3.29	-0.79	-4.30	-2.07
PE Agg GLA-Tsy TR Unh US	-5.82	13.60	-1.22	-7.82	0.47	4.47	3.67
Global Agg - Germany	-4.16	12.06	0.36	-8.94	-3.70	2.59	-1.79
Global Agg - Italy	-10.84						-10.84
High Yield							
US Corp High Yield	0.89	7.50	17.13	-4.47	2.45	7.44	30.95
Pan-Euro HY Unh Eur	-1.22	6.24	6.48	2.92	7.02	9.90	31.34
EM USD High Yield	-4.88						-4.88
EM Local Currency Govt	-6.36	14.27	5.86	-10.38	-1.91	-4.32	-2.84
EM Asia USD Credit USD	-2.34	5.58	5.83	2.67	8.30	-1.46	18.58
Inflation Linked							
Global IL: US TIPS TR U	-1.67	3.01	4.68	-1.44	3.64	-8.61	-0.39
Global IL: Germany TR U	-3.29	13.25					9.96
BBG AUB Infl Govt 0+Y	2.49	3.73					6.23
Global Inflation-Linked:	-7.34						-7.34
Australian Bonds & Corporates							
BBG AUB Comp 0+Y	2.80	3.66	2.92	2.59	9.81	1.99	23.76
BBG AUB Credit FRN 0+Y	2.04	3.45	3.10	2.69	3.94	4.20	19.42
Commodities							
BBG Energy	11.89	-5.21	15.89	-38.91	-39.36	5.13	-50.57
BBG Industrial Metals	-15.14	28.13	19.52	-26.92	-6.90	-13.68	-14.99
BBG Precious Metals	-9.63	9.90	9.14	-11.50	-6.74	-30.84	-39.68
Major Equities							
S&P 500 INDEX	0.98	21.82	11.95	1.37	13.68	32.37	82.18
NASDAQ COMPOSITE INDEX	4.69	29.73	8.97	7.11	14.83	40.17	105.49
FTSE 100 INDEX	-6.51	11.95	19.15	-1.37	0.72	18.65	42.60
DAX INDEX	-13.29	12.51	6.87	9.56	2.65	25.48	43.79
CAC 40 INDEX	-3.85	12.54	8.81	11.94	2.54	22.23	54.21
NIKKEI 225	-4.50	21.34	2.38	10.99	8.96	59.37	98.54
HANG SENG INDEX	-14.57	41.27	4.28	-3.92	5.31	6.56	38.94
CSI 300 INDEX	-19.52	24.25	-9.25	7.23	55.84	-5.33	53.22
S&P/ASX 200 INDEX	-1.48	13.41	13.42	4.20	7.15	21.98	58.67
Volatility							
MOVE	34.56	-34.95	5.57	-1.58	-6.26	23.81	21.16
CBOE 10y US Trs Note Vol	33.24	-34.81	8.87	-7.29	4.29	9.85	14.14