

The Fix

An unhealthy addiction

Stuart Dear, Fund Manager, Fixed Income

The world's financial markets maintain an unhealthy addiction to policy accommodation, even if the economic benefits of it are uncertain. Somewhat perversely now, weak data is cheered because it means accommodation will last for longer or will be employed even more powerfully. Central bankers – up against structural shifts in the global economy - have been left with mandates to control economic variables (growth and inflation) with tools (conventional and unconventional policy instruments) that cannot target those variables directly and are of limited use in a world that is both oversupplied and overleveraged. Lopsidedly, the returns from policy accommodation continue to accrue in the financial rather than in the real economy. To overcome these failings, central banks have, implicitly, incorporated an assessment of financial conditions in their policy deliberations. This has been a necessary but fraught development, as markets have learnt that they have the upper hand in this game of chicken – markets get withdrawal anxiety, central banks balk at accommodation withdrawal, markets recover. Markets will likely get anxious again before December's FOMC meeting.

The mediocre-growth, low (real economy) inflation world that supports this market environment hasn't changed materially through the course of the year - though there has been considerable rebalance of exchange rates, incomes (via commodity price shifts) and stores of wealth (reserves) between countries - but it won't last forever. Our central expectation is that economies ultimately step back towards normal conditions and rates of return on investments are more closely linked to those economic outcomes. Policy begins to operate normally, risk and capital are more appropriately allocated. The alternate scenario, one where policy accommodation proves ineffective in normalising economies, likely involves deflation and a general retreat from risk assets. Given the reasonable probabilities that can be attached to each of these non-priced scenarios, we think it pays to continue to be cautious.

We continue to run a duration position materially shorter (-1.50yrs) than the valuation-agnostic benchmark. Valuations are at the core of our approach and while we generally accept that in the short run valuations are a poor forecasting tool, they matter over the medium term. Valuations of sovereign bonds are expensive versus even conservative estimates of normalcy, and imply both low future returns and a high probability of loss. Most of our short is in the US, because while valuations are expensive everywhere, the relative outperformance of the US economy and proximity of Fed tightening should continue to see Treasuries underperform. Smaller shorts are held in Australia and Germany on valuation grounds. While we have been right on our country-relative views, the overall inability of yields to rise through the year has been a disappointment, to which we have partially responded by structuring our short exposures to minimise the carry drag of running a short with the timing of payoff uncertain. This has mainly involved positioning for a steeper US curve and flatter Australian curve. In time we are likely to also rebalance our aggregate exposures between countries but for now are largely holding these steady.

Having pared our credit exposure into the August-September weakness, we have a more constructive view on credit now than previously, and have added back a little to our Australian corporate exposures. We see valuations in credit being about fair, with recession (which drives defaults) unlikely, though we remain cautious generally, especially given some deterioration in corporate fundamentals and in market liquidity conditions. Our preference remains for high quality shorter tenor bonds, though subordinated local bank paper is back on our radar with spreads widening on regulatory-induced issuance. We continue to run a collective underweight position to the non-credit spread sectors (i.e. semis and supras) given the modest additional return they offer versus government, though diminished relative supply versus government bonds should see these sectors relatively well supported.

Preserving capital as markets adjust is a priority; 2015 has made it clear that patience is required. Effective cash remains above 25% and the portfolio is well positioned to continue to provide defensive absolute outcomes and be able to take advantage of the developing opportunities.

Important Information:

Opinions, estimates and projections in this article constitute the current judgement of the author as of the date of this article. They do not necessarily reflect the opinions of Schroder Investment Management Australia Limited, ABN 22 000 443 274, AFS Licence 226473 ("Schroders") or any member of the Schroders Group and are subject to change without notice. In preparing this document, we have relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources or which was otherwise reviewed by us. Schroders does not give any warranty as to the accuracy, reliability or completeness of information which is contained in this article. Except insofar as liability under any statute cannot be excluded, Schroders and its directors, employees, consultants or any company in the Schroders Group do not accept any liability (whether arising in contract, in tort or negligence or otherwise) for any error or omission in this article or for any resulting loss or damage (whether direct, indirect, consequential or otherwise) suffered by the recipient of this article or any other person. This document does not contain, and should not be relied on as containing any investment, accounting, legal or tax advice. Schroders may record and monitor telephone calls for security, training and compliance purposes.