December 2018

Quarterly Commentary

Australian Fixed Income

Market Review

The quarter served up a weaker-than-expected GDP print for Australia, featuring lacklustre income and spending. This injects some volatility into the key economic data as it follows a strong second-quarter reading and accompanies solid labour market data. House prices continued to correct lower against a backdrop of diminished credit availability.

In China, steps to stimulate have intensified and infrastructure investment rebounded, but broader activity data was weak and the widely watched manufacturing PMI fell below 50, the critical level that is consistent with stable output.

The much-anticipated US mid-term elections saw the Democrats take control of the House of Representatives and the Republicans regain control of the Senate, as widely predicted. This reduces the likelihood of another round of tax cuts, which matters for risk assets because the earlier outperformance of US equities is arguably attributable to corporate tax cuts and buybacks (prompted by repatriated foreign earnings). The labour market remains strong and wage growth accelerated even while consumer price inflation was more stable, allowing the Federal Reserve to tighten monetary policy in December but accompany the move with dovish signals. This rhetoric increased as the quarter progressed and risk assets sold off.

In Europe, the risk of a no-deal Brexit has increased for the UK. In Italy the government backed down on its budget deficit target amid pressure from the EC and markets, while in France the purse strings have loosened after a series of protests. For the Eurozone as a whole the industrial sector continues to languish but the ECB is upbeat on account of positive developments in domestic demand.

The period saw a substantial rally in global bonds, led by the US. Ten-year US Treasury yields were down 38 basis points to 2.7% and Australian ten-year bonds moved roughly in line to end the year at 2.3%. The risk off sentiment sent the AUD lower by 2.4% against the USD to 70 cents.

Outlook

We retain high conviction that the Australian economy will emerge unscathed from the various self-inflicted problems it has been navigating, across the realms of housing and lending and politics. Wealth effects are always discussed in Australia because of the importance of the housing cycle historically, but our analysis over the years has highlighted important changes in the transmission channels. In any case, wealth effects have a chequered history in the literature and are not just based on the notion that households spend more because rising prices make them feel better.

Furthermore net household wealth has held up as far as the latest data for mid-2018 shows. The recent unemployment rate downtrend to 5% should not be dismissed and we believe will hold significance in the mind of the Reserve Bank of Australia (RBA). A shift in rhetoric should come in the first half of 2019 to prepare markets for an increase in the cash rate in the second half.

The US is in a state of flux, as activity will soon slow from above trend levels but inflation will do the opposite. The wage data is responding already to a tight labour market and is in line with our own preferred Phillips curve. We expect further acceleration ahead in wage growth and, eventually, an impact on consumer prices which will see a breach of the Fed target. The activity data and equity market has been lifted by tax cuts which will not have a lasting impact, and trade tensions will slowly weigh down the economy through increasing costs and supply-side price increases. The Fed will nevertheless need to carry on withdrawing stimulus and strategically providing anodyne comments to appease risk assets – just enough to see the economy slow moderately. It will prove a difficult road to travel on. China on the other hand is in the midst of activating stimulus through infrastructure investment in large part, although it has not been sufficient to offset slowing in other sectors such as property. The Eurozone awaits a rebound after various temporary factors have clouded the signal-to-noise ratio in the economic data, but the ECB appears set to follow a pre-set path with a light version of targeted longer-term refinancing operations (TLTRO) appearing sometime next year.

There are competing drivers for credit markets at present. However, our core expectation is for a more challenging backdrop for credit in the medium term, as mentioned last month. Our recently completed macro strategy paper outlines growth downside risks as key developed economies (such as the US) enter the later stages of the cycle. The positive factors remain, namely US growth, historically low interest rates and buoyant corporate earnings.

Aberdeen Standard Investments

Indeed, strong credit returns persisted through to February of this year. However we feel some pricing for geopolitical risk (including trade tension) and the turn in the policy cycle is apt in a year where central banks reduce their levels of accommodation. The recent Italian deficit concerns have been amplified by the imminent winding back of ECB largesse. In some cases, especially select local currency emerging market debt markets, risk premia have moved spectacularly. Less so in developed markets. Inflows into fixed rate credit have slowed and more recently it is the low-duration loan funds that have received the bulk of new inflows. New issue supply will respond, with loans seeing a new issue pipeline up to seven times the size of the (fixed rate) high yield market. The increased nervousness about tenor (duration) risk in credit, rather than an imminent spike in defaults, is the culprit and we expect this to continue. Overall, we feel that approaching credit from a 'sell the rally' angle makes more sense than the 'buy the dip' mantra that was so powerful in 2016 and 2017. For these reasons, we have further reduced our credit allocation, partly through derivatives and partly involving movement into more liquid and higher-rated names. There are still opportunities to create value and we are alert to these. Ultimately, given we expect default rates to stay low, a degree of credit overweight is warranted but at reduced scale.

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