portfolio construction forum

MARKETS SUMMIT

Australian gov't bonds can still provide positive returns

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The winds of change: a necessary philosophy and outlook

Approach: Invest for the long-term, **be well diversified**

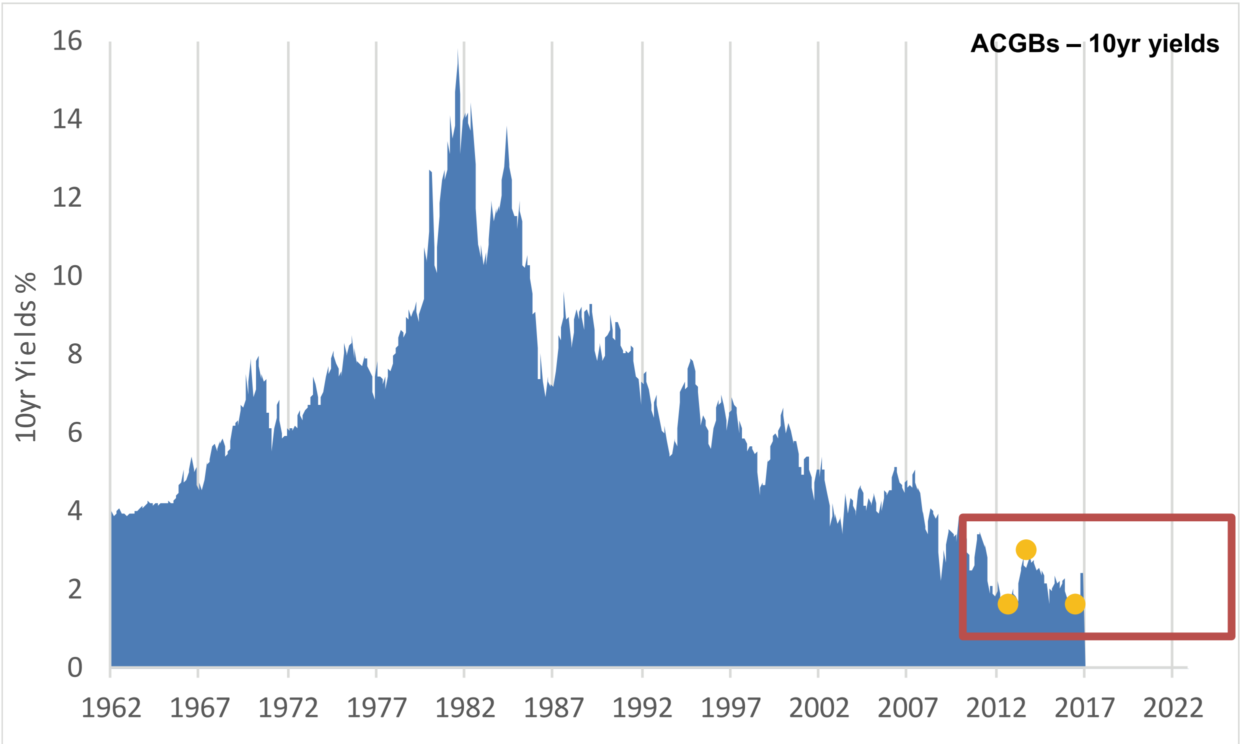
Behavioural: Avoid over-reactions, focus on **risk management**

Macro Outlook: Widened outcomes: **uncertainty & volatility**

Tools: Deploy the **right skills & strategies for the given challenges ahead**

After a powerful trend, a period of consolidation is likely

The market is unlikely to reverse without incident…



Source: Bloomberg - Jan1962 to Jan 2017 (monthly). Past performance is not indicative of future performance.

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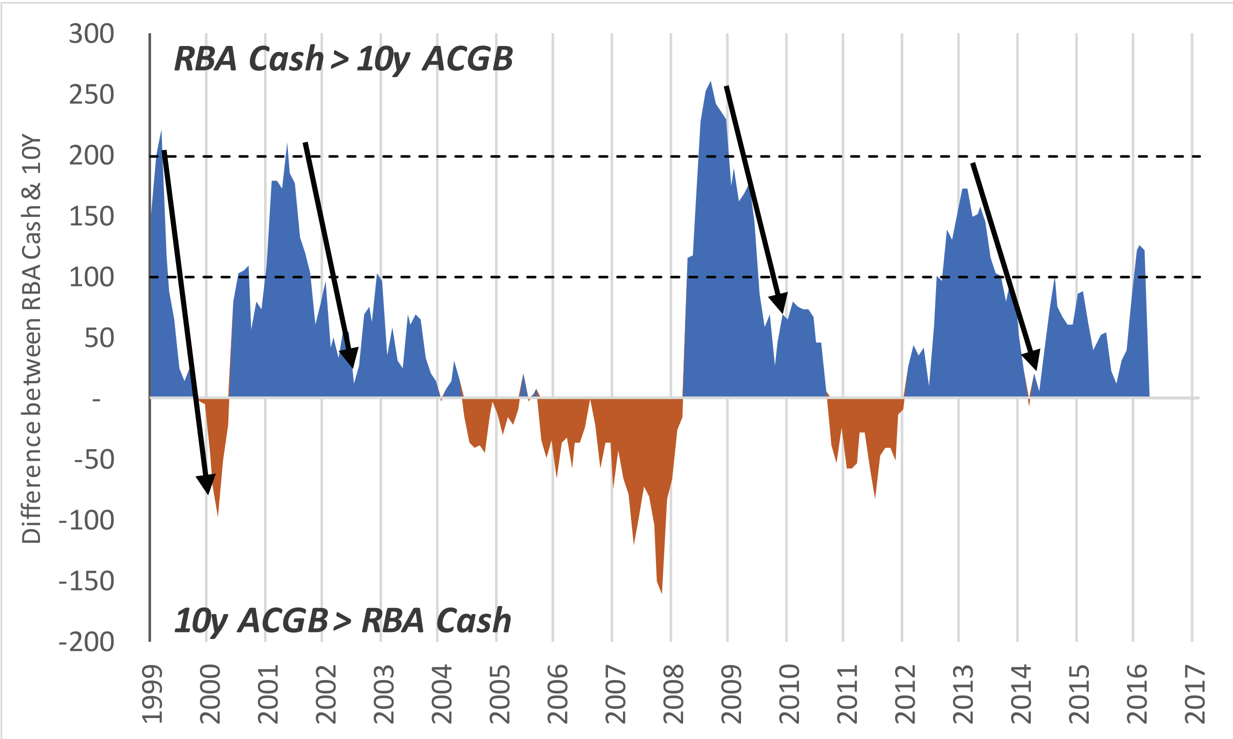
The current economic backdrop, combined with insights from historical relationships, suggest something has to give

Spread between RBA Cash & 10Y yields – a canary in the coalmine



Source: Bloomberg and JCB team analysis.
Past performance is not indicative of future performance.

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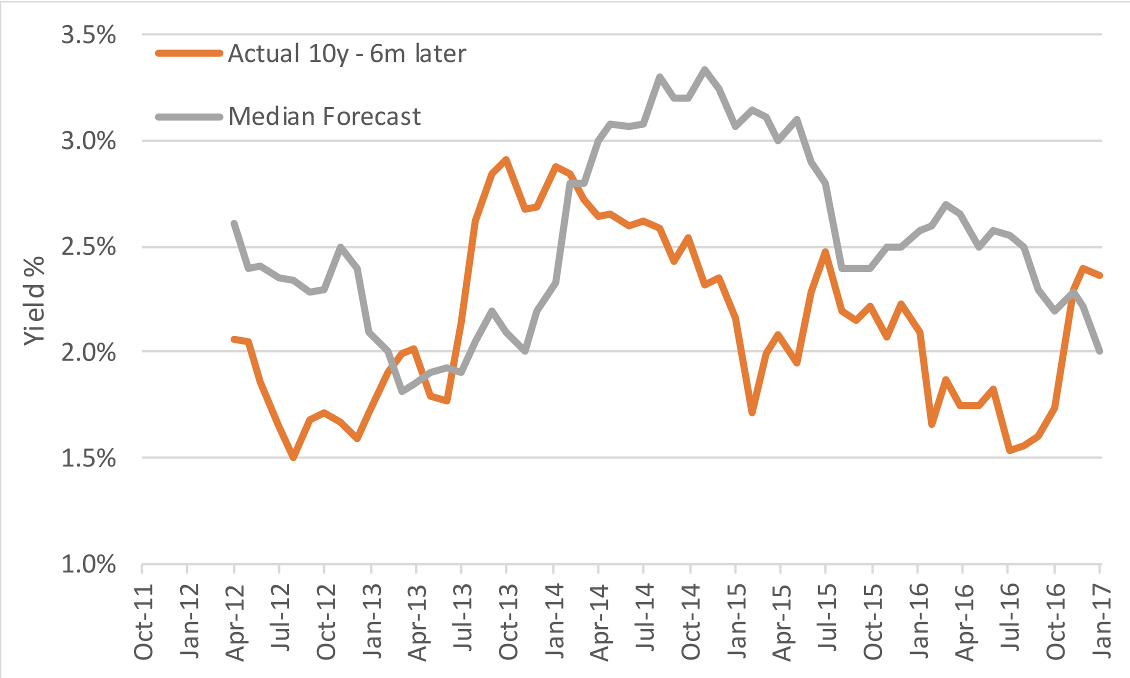
Economists' forecasts are not always reliable

Bloomberg Survey (in the US) of interest rate forecasts six months forward



Since Sep 2011, economists have only predicted falling rates once (in the wake of the Trump election)

On average, 90% of respondents expect higher yields

In reality, rates rose 42% of the time

Positioning and flow of funds mark the signposts

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Source: Bloomberg - Jan1962 to Jan 2017 (monthly)

Markets: the range of possibilities has increased dramatically

Bonds' underlying design means that they can potentially perform & defend in portfolios over different market conditions

	2017 Aus Bond scenarios	Why	Prob	10y yield	Projected 1y return*
1	"Bond bear market"	■ Growth assets surge, no dent in growth story; sustained growth ■ US Fed: 3 (or more) hikes	15%	3.65%	-0.2%
2	"Steady as she goes"	■ US Fed 2-3 hikes (2.7 hikes currently expected)	40%	2.85%	3.0%
3	"Bond solid performance"	■ Trump delivery shortfall ■ Debt servicing costs have jumped ■ US Fed 2 hikes (as currently expected)	30%	2.51%	5.3%
4	"Bond bull market"	■ Significant market stress (political, geopolitical, war, terrorism, disaster) ■ Credit event; flight to quality	15%	2.02%	7.7%

Source: Estimations are based off JCB team analysis using data from Bloomberg. Returns are not guaranteed, and illustrate, as at December 2016, a view of the coming 12 months for the Aus Govt bond market.
* Of the Aus Govt bond benchmark, Bloomberg AusBond Treasury 0+ Yr Index

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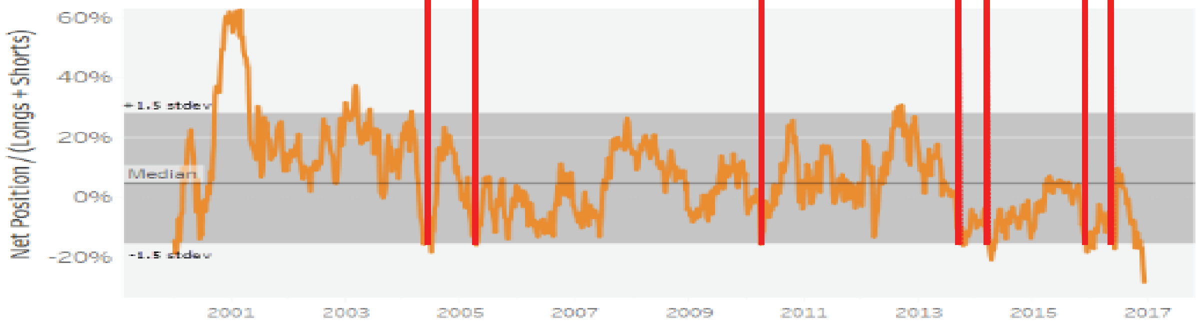
Forming a volatile base in global rates

Bond sentiment currently once in a generation extreme; previous smaller positioning has generated rallies of 50 to 100bps

US 10 Year Note Yield (%)

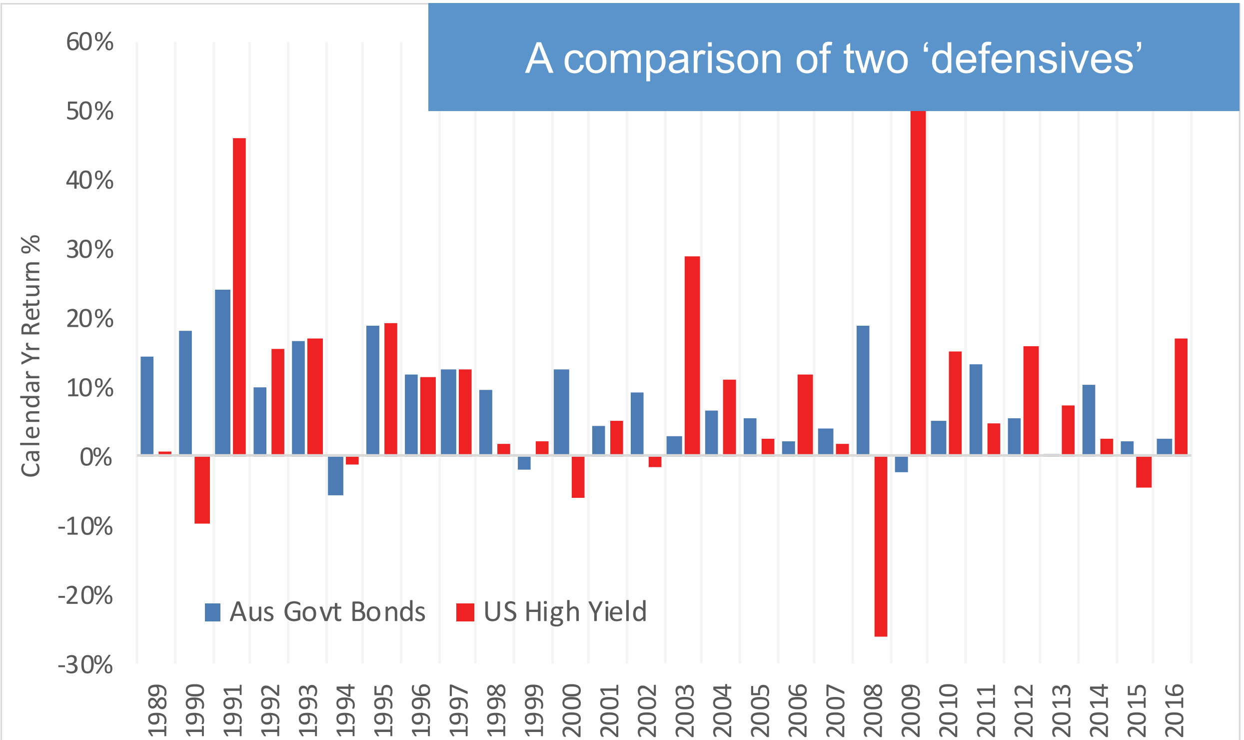
Positioning (non-commercial) for Eurodollar, 2, 5, 10 and 30 year futures



Source: Bloomberg - Jan1962 to Jan 2017 (monthly)
Past performance is not indicative of future performance.

What does a ‘truly defensive’ exposure look like?

Aus Govt Bonds and US High Yield since 1989 (28 years of history)



Source: Bloomberg – to Dec 2016. Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged USD and Bloomberg AusBond Treasury 0+ Yr Index. Past performance is not indicative of future performance.

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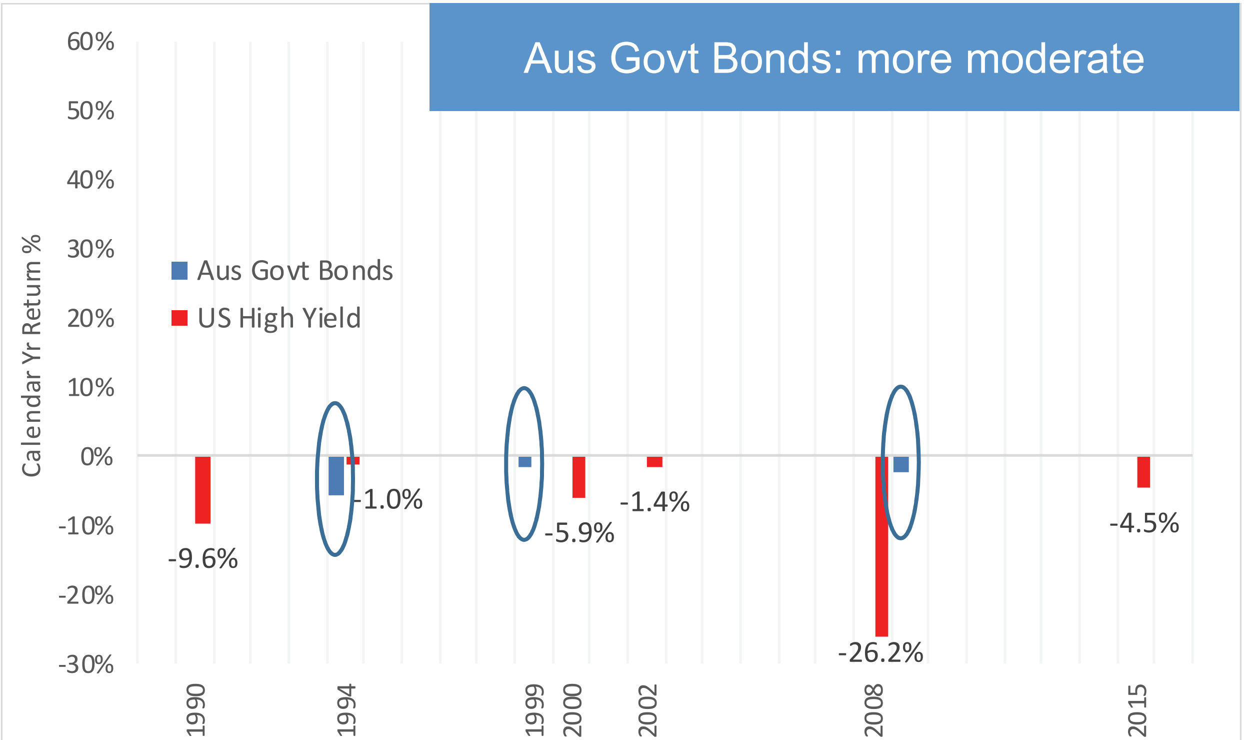
When is the next credit event likely to happen in Australia?

Negative years only: Aus Govt Bonds and US High Yield



Source: Bloomberg – to Dec 2016. Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged USD and Bloomberg AusBond Treasury 0+ Yr Index. Past performance is not indicative of future performance.

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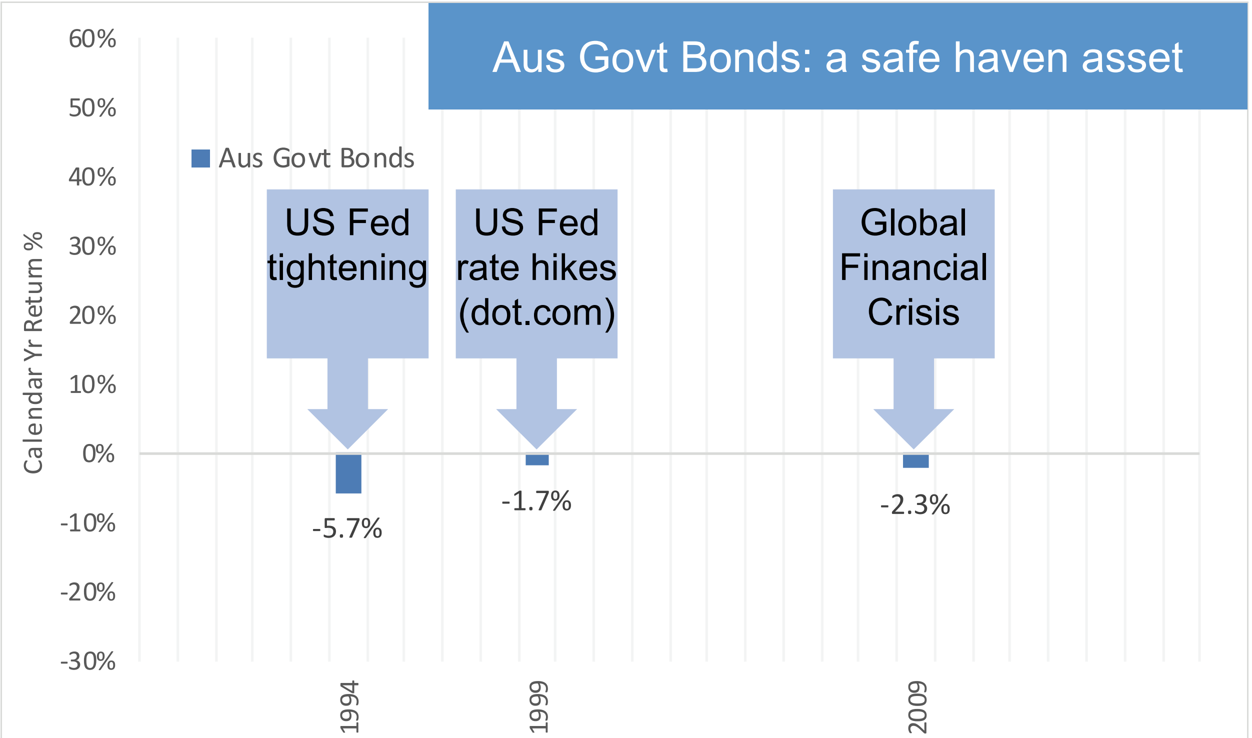
Aus Govt Bonds can protect on the downside

Aus Govt Bonds (negative years): far more moderate, and less of them



Source: Bloomberg – to Dec 2016. Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged USD and Bloomberg AusBond Treasury 0+ Yr Index. Past performance is not indicative of future performance.

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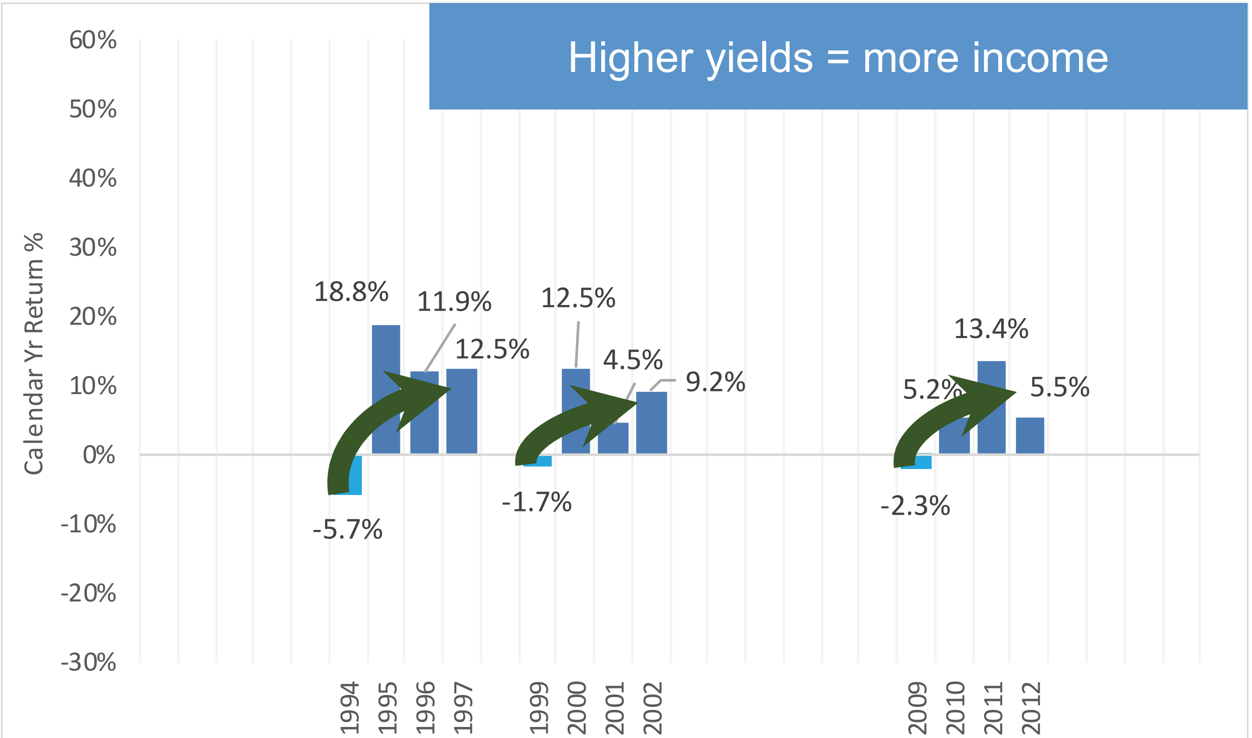
Aus Govt Bonds: self-rebalancing & long-term beneficial

Three (3) negative years since 1990 – what happens in subsequent years?



Source: Bloomberg – to Dec 2016. Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged USD and Bloomberg AusBond Treasury 0+ Yr Index. Past performance is not indicative of future performance.

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Adopting a risk first approach to portfolio construction

How do I think about risk?

MARKET RISK: Top Down Fundamental Macro inputs

- Macroeconomic indicators
- Data releases
- Global supply implications

INVESTMENT RISK: Bottom Up Micro inputs

- Supply & flow of funds
- Technical, yield curves
- Quantitative insights

Constantly think about the **balance** of risk-seeking and risk-aversion

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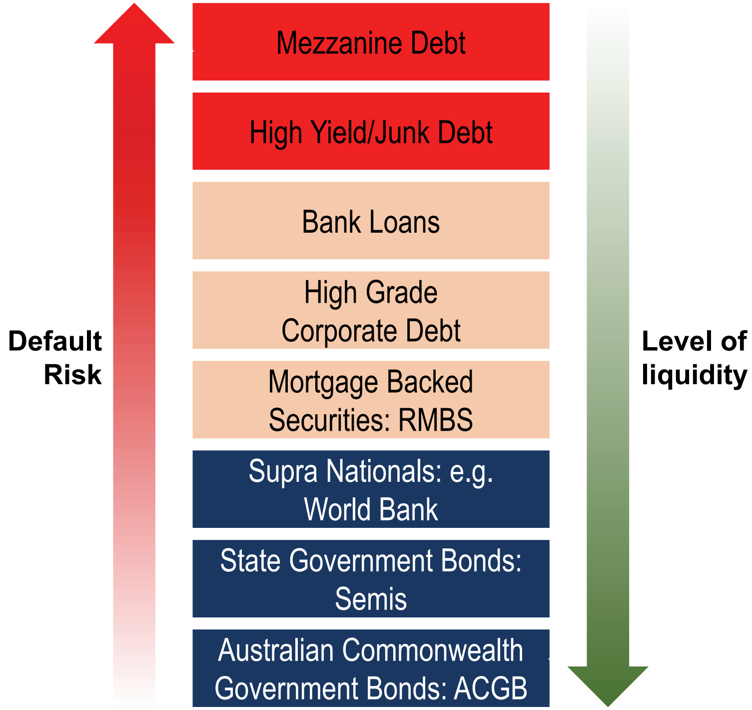
Aust Govt Bonds can provide positive returns

- **The RBA - unlikely to hike in 2017.**
  - potentially leading to positive bond market returns
  - much of the bond market re-pricing is now largely complete.
- **In the medium term, financial tightenings* have preceded every recession of last 40 years.**
  - At some point higher rates will hurt growth / risk assets and lead to bond strengthening.
- **Tail risks protection is critical for portfolios subjected to Trump geopolitics.**



Source: JCB team analysis.
* e.g. higher cost of capital

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