ARE BOND YIELDS THE SIGNPOSTS FOR GLOBAL ECONOMIC GROWTH?

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On a global and regional level economies are travelling at two different speeds. At a company level in Australia and Asia, research is showing positive developments and signals, evidenced by strong balance sheets and generally consistent local demand. However at the macroeconomic level, overshadowed by debt problems in Europe, the signs seem more pessimistic. In short, there is the complex problem of a strong Asia Pacific region and a weaker Europe. Managing this duality is a focus for policy makers and investors alike. This paper examines ways in which active fixed income investing can potentially navigate the current environment and how analysis of relative bond yields provide signals to efficient defensive sector portfolio construction and asset allocation.

It is official – the days of the corporate freebie are not over. While Las Vegas and Dublin hotel occupancy rates are suffering from the increasing public frowning on pre-GFC finance industry corporate sales junkets, the manufacturing industry in many of China's booming coastal cities is introducing the concept of the monthly and annual staff daytrip. It may be that life on the production line of manufacturing companies is not terribly exciting, or it could be the current high demand for labour and pressure on Chinese average wages; but what is clear is that certain economists are using this anecdote of increasing Chinese wages and a subsequent rising of global inflationary expectations as evidence of brighter times ahead.

The contrasting view comes from George Soros who according to a recent speech at a conference in Vienna in early 2010 is forecasting darker days ahead. "Indeed, we have just entered Act II of the drama, when financial markets started losing confidence in the credibility of sovereign debt. Greece and the euro have taken centre stage, but the effects are liable to be felt worldwide. Doubts about sovereign credit are forcing reductions in budget deficits at a time when the banks and the economy may not be strong enough to permit the pursuit of fiscal rectitude," said Soros.[1]

Similarly, dualities exist, where at a company level in Australia and Asia, developments and signals are very positive evidenced by strong company balance sheets and generally consistent local demand.[2] However at the macroeconomic level, the signs could be considered to be more pessimistic. These include a weakening European growth outlook; the prospect of tougher-than-expected global financial market regulations; worries that China will over-tighten monetary policy in order to cool a heated property market; and an escalation in geo-political tensions evidenced by events in the Korean Peninsula. The strong recovery in market signals and economic statistics in the US economy ground to a halt in early June 2010 with recent labour figures stalling. In addition, the UK Chancellor has just announced its most austere budget since Geoffrey Howe's budget in 1981.[3]

The Reserve Bank of Australia (RBA) is carefully signalling its future monetary tightening intentions, and while believing Australian interest rates are approaching their long-term neutral levels, in a statement to the media on 9 June 2010, RBA Governor Glenn Stevens emphasised caution over the seemingly bullet-proof Australian economy. "It cannot be denied that the potential for further

financial turmoil exists. Much still hinges, however on the way European policy makers craft their ongoing response to a complex problem," said Stevens.

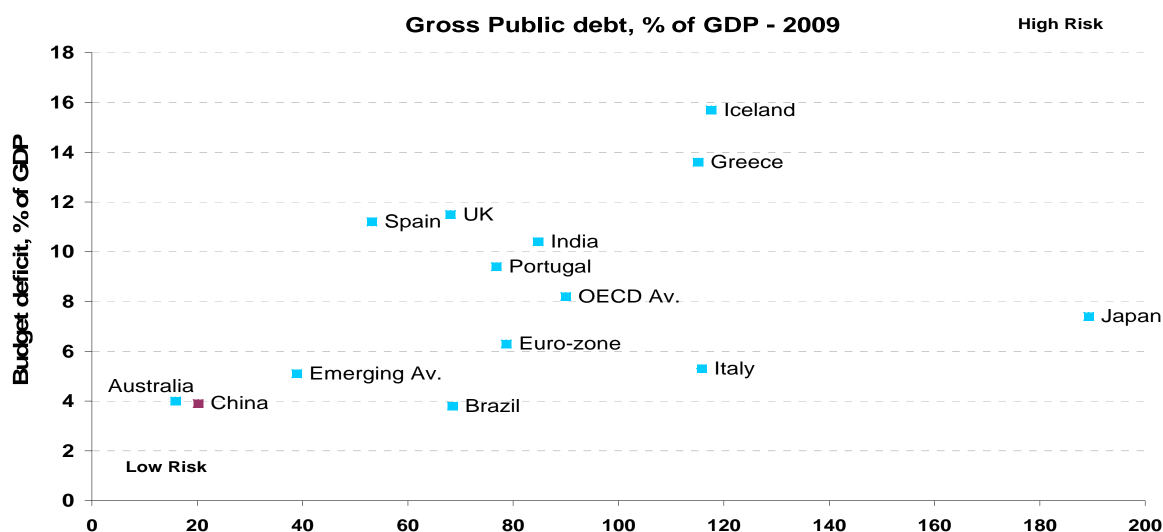
In short, there is the complex problem of a strong Asia and a weaker Europe, in other words a two speed global economy. In Australia growth in banks' balance sheets are likely to be constrained by global regulation and offshore wholesale markets, while increases in spot iron ore prices seem limitless. Consequently, the direction of bond yields may well provide the clue to where global economic growth is really heading.

Managing risks in global fixed income

For global bond investors, it is a time for clear understanding of relative risks, mapping upcoming sectors that are focussed on refinancing, and applying fundamental valuations to market risk premiums. Many global bond investors have reacted positively by ensuring their investment managers' high conviction views can be implemented efficiently without the constraints of all-inclusive benchmarks and tight active risk constraints.[4]

Figure 1 below shows the relative debt positions of Greece, Spain, Italy and Portugal relative to the OECD average and the emerging markets average.

Figure 1: The relative debt positions of selected European countries



Source: OECD, International Monetary Fund, AMP Capital Investors, 2009

Confusingly for some, this active management focus has resulted in global government bond portfolios performing relatively well year-to-date. The coordinated actions of Quantitative Easing (QE) by central banks and investors 'flight-to-quality' has ultimately acted to overcome concerns of a bond sell-off from the wall of sovereign debt supply hitting markets. However, as New York

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University Professor of Economics Nouriel Roubini stated on January 2010, "Unless advanced economies begin to put their fiscal houses in order, investors, bond-market vigilantes, and rating agencies may turn from friend to foe." [5]

Stage two of the sovereign debt crisis may have a more significant effect on the capital preservation strategies of investors. The competition for the financing of these large sovereign deficits, or 'crowding out' effects may cause US and Japanese sovereign bonds to sell off. Investors should be wary of predicting the timing of stage two but there are alternatives to avoiding this next and possibly most damaging stage for defensive investors.

The tilt towards Asian bond markets

Investors need to consider investing more in markets which don't suffer from high debt levels and demographic constraints to the same degree as most developed countries do. Asian and emerging markets generally are high on the list on this front. With the notable exception of China, the populations of emerging economies are younger, and the dependency ratio, the ratio of retired older people to those of a working age, more favourable[6]. These economic fundamentals should flow through to improved relative credit-worthiness for many Asian economies and hence into lower relative spreads above triple A-rated sovereign debt from developed countries. These macro factors are also likely to have particularly beneficial effects for Asian currencies relative to the value of developed market currencies such as the US dollar, euro and UK pound sterling.

The currency argument for Asia

The rationale for a generally positive view on the prospects for Asian currency appreciation is as follows (although there will be a range of outcomes amongst the constituent countries):

- The balance of payments is generally positive amongst Asian economies, particularly those that rely on exports for their economic growth.
- Large foreign exchange reserves are generally available to support the currencies of Asian economies.
- Asian economies appear to have become more adept at managing inflation, thereby protecting the real value of their currencies.
- Many Asian economies (China now included to some extent) have reduced or removed exchange controls and have introduced fully or partially floating exchange rates. This helps avoid sudden and dramatic exchange rate movements, resulting in more stable economies and exchange rates longer term.
- The currencies of many developed economies are under pressure because of weakened economies following the credit crunch. Longer term, high national debt is likely to result in higher taxes and subdued economic performance which again signals lower short term interest rates and lower demand for that currency. In effect, this has been seen in many European countries recently.

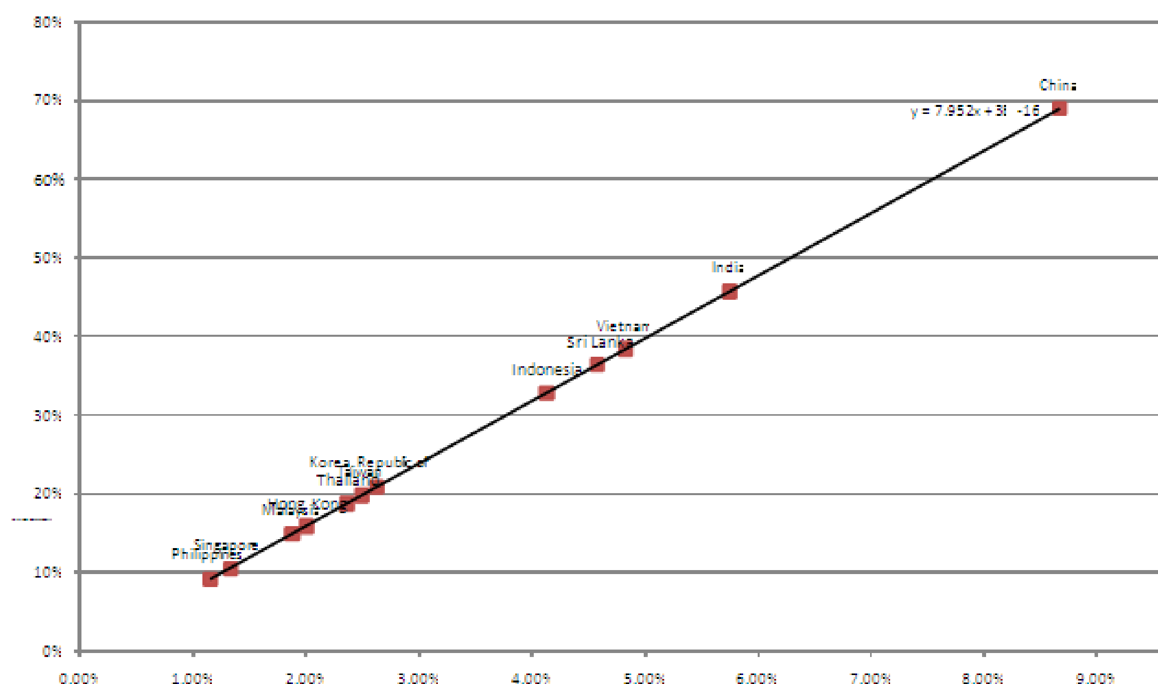
Medium-term expectations of the extent of Asian currencies appreciation - a theoretical study

Dekell[7] recently began an in-depth analysis into the prospects for appreciation of Asian currencies. The usual framework for calculating relative currency changes is the Purchasing Power Parity (PPP) hypothesis, however its main criticism is that it tends to be backward-looking. In recognition of these limitations, Dekell extended the research to include the Balassa- Samuelson hypothesis which gives both a long-term path for real exchange rate appreciation and by looking at fixed one year data, is also a short-term indicator of relative under (or over) valuation.[8]

The Balassa–Samuelson (BSH) hypothesis implies that countries with rapidly expanding economies should tend to have more rapidly appreciating exchange rates. If all countries operated in a stable manner then if, for example, China is growing 7% a year faster than its trading partners, it should experience a corresponding trend of currency appreciation. However, in reality, the exchange rate can be temporarily pulled away from its long-run equilibrium value by factors such as discrete devaluations, fluctuations of larger anchor currencies, monetary expansion and speculative bubbles. While these temporary valuation factors are expected to self-correct themselves over time and for the currency to regress back to the stable equilibrium line, change is never rapid and the tendency to close the gap was found to occur at a rate of “one half the gap per decade”. This expected time line is one of the major initial findings of this research.

When investors in general think about the BSH theory, it is usually assumed that the relevant country lies right on the BS equilibrium relationship. This equilibrium is described in most cases by a statistically significant relationship between the change in per capita GDP and the Real Exchange Rate (RER). Figure 2 below has blended IMF forecasts for per capita growth in a basket of Asian countries in the period from 2007 to 2015, combining this with a long-term equilibrium relationship to predict changes in the real exchange rate.[9]

Figure 2: Expected change in the real exchange rate using selected countries (2007-2015)

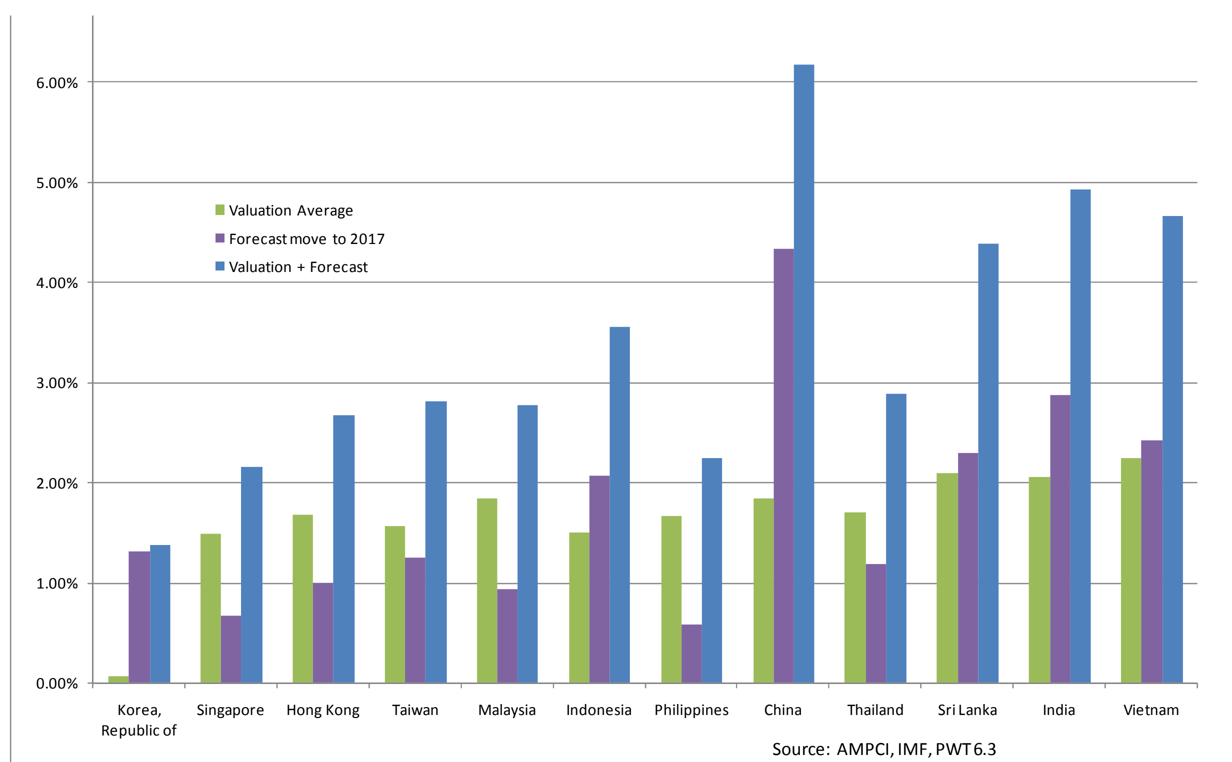


Source: AMP Capital Investors, IMF, PWT 6.3

To illustrate with round numbers, prices in China are about one tenth the level of prices in the US. Some of the gap can be explained by the fact that real incomes in China are about one eighth the level of the US, but not all. The Renminbi is still undervalued by about 40% when judged relative to the equilibrium Balassa Samuelson line. The estimate that half of the gap might be expected to close per decade implies real appreciation of approximately 20% over 10 years, or an average rate of 2% per year. Consideration of PPP methodology/hypothesis gives a similar but higher number for China. Combining with the estimate that Chinese growth remains 7% above US growth, the predicted movement along the BS equilibrium line is around 4% a year. Adding these two numbers together results in an estimate of total future appreciation of the RMB of about 6% a year from 2007 levels.

Using this methodology for other Asian countries yielded the results shown in Figure 3. The blue bars show the total expected currency appreciation using this combined analysis.

Figure 3: Total expected currency appreciation for select Asian countries (% pa returns)
(2007 – 2017)



Source: AMP Capital Investors, IMF, PWT 6.3

Dekell came to the following initial conclusions:

- Allowing for the fact that Asian currencies are generally not freely floating currencies, significant relative appreciation is expected of Asian currencies.
- This currency appreciation is conservatively expected to be between 1% and 6% per annum depending on the country of origin.
- As part of portfolio strategy, these dynamics leads to considering being strategically long a basket of Asian currencies as a natural position for fixed income investors.
- The Asian regions' currency appreciation is a natural response to the fundamental need for China and its close competitors to shift from an export-oriented toward a more consumer-led economy.
- A lot more work is required on the relative robustness of respective models but an Asian currency trading model is under development.

Don't forget Australian fixed income

According to the latest Budget handed down by the Australian Labor Party in May 2010, current forecasts expect the budget to return to surplus in 2012-13.[10] Australia also looks to be firmly in the group of countries that are certain of retaining their AAA ratings status. Inside the Australian private sector, strong jobs data for May 2010 have provided a welcome relief after a run of poor economic data lately. The continuing strong improvement in the labour market, with 141,000 jobs created so far this year, of which 139,000 were full time, will help underpin household income growth and along with July's income tax cuts should help boost consumer spending going forward.[11]

In Australia, the real effect of a two speed economy is evident especially for investments outside of the sovereign sector. The dichotomy exists for policy makers between managing the growth part of the economy such as resource and energy companies, and managing the leveraged household sector that has most of its liabilities attached to the 'big four' Australian banks. The impact of global regulation teamed with little capacity for credit growth in banks suggests a strategy of seeking out increasingly more corporate debt from capital markets in the non-financials sectors of the market, particularly those that demonstrate the twin pillars of strong balance sheets and positive cashflow.

Some of these sectors include prime retail shopping centres, A-grade office buildings and Australian prime residential mortgages. The utilities and infrastructure sector is also looking particularly attractive. The majority of infrastructure and utilities companies have, as a basic attribute, strong and stable underlying cash flows. Regardless of how the economy is doing, there is ongoing demand for their assets and services, such as roads and electricity, to meet day-to-day living needs. Hence the demand for infrastructure and utilities is relatively inelastic to the economic cycle, meaning they are typically conservative predictable businesses. This makes their debt securities a compelling proposition for corporate bond investors as they have the potential to provide high income stability. Facing significant refinancing obligations, infrastructure and utilities will be forced to diversify funding sources, with capital markets issuance expected to increase throughout 2010.[12]

Near term liquidity and regulatory risk for Australian banks

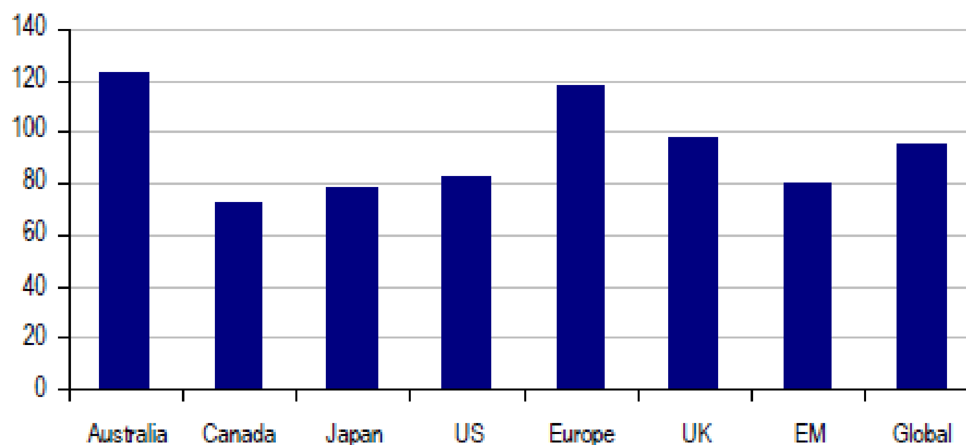
Hyde-Smith[13] conducted an in-depth analysis of the key risks facing Australian banks as global regulation becomes reality on the back of recent G20 meetings. The need for the big four Australian banks to consistently access wholesale funding from global investment markets is a well known point. The extent of this funding requirement (particularly by the two banks that participated directly in the booming first-time home buyer market in late 2009) over the course of the next five years is perhaps not so widely appreciated. To continue to refinance debt and grow balance sheets in line with the market consensus for earnings, particularly at a time when global markets are volatile and fund raising difficult, is looking more and more problematic. There are no change from the trends of 2009 shown in the statistics below. Figure 4 shows the ranking in terms of debt issued to total assets ratio in 2009. Australian banks heavily feature in this table.

Figure 4: Top global bond issuers 2009

Rank	Issuer	Total Assets ($bn)	Debt Issued ($bn)	Yearly Issuance to Asset ratio
1	WBC	521	61.0	11.7%
2	CBA	501	48.2	9.6%
3	GECC	782	68.3	8.7%
4	Rabobank	871	46.1	5.3%
5	ANZ	422	21.5	5.1%
6	Svenska Handelsbanken	297	13.8	4.7%
7	Citigroup	1857	82.3	4.4%
8	NAB	578	21.2	3.7%
9	Lloyds	1659	56.9	3.4%
10	Dankse	597	15.6	2.6%

Source: Bloomberg, Dealogic

Figure 5: Loans to deposit ratio 2010 forecast



Source: UBS estimates

Figure 5 shows the relative challenges for Australian banks' liquidity relative to other countries by their total loans to deposit ratio on 2010 forecast metrics. On these metrics, Australia has to seek more deposits to maintain liquidity at current credit levels. As Glenn Stevens reminded people recently, Australians need to increase savings and reduce household debt while times are generally good.

APRA has conducted its own review of the ability of the Australian banking system to withstand stress testing based on conditions worse than the financial crisis, pronouncing Australian banks as being robust. Much of the analysis conducted by APRA assumed a strong residential housing market

sector, certainly a given for the last 18 years or so.[14] APRA Chairman, John Laker stated in June 2010 that Australia's relatively strong fiscal position can be a hindrance as this perversely penalises the local banking sector's ability to meet new liquidity rules. "Countries which have no trouble meeting the Basel requirements are those whose governments have been pumping bonds out because they need to bail out the banking system. So we're in a very awkward position," said Laker.[15]

Hyde-Smith concluded that the key risk to the performance of Australian banking credit comes from near term liquidity risk, and regulatory risk linked to Basle III recommendations for banks.[16] The implication is a potential future risk to portfolio performance from holding too much concentration in senior debt issued by Australian banks.

Conclusions

The combination of high private and public sector debt levels in developed countries, extreme swings in fiscal policy, and greater government involvement in the economy is likely to mean investors have entered a more volatile macro economic environment. G3 countries' sovereign debt is offering historically low yields that it is hard to argue adequately compensate investors for the macro economic headwinds on the radar. Conversely, within Australia and parts of Asia, corporate balance sheets are in relatively good shape and yields for fixed income investors are expected to remain at high levels relative to the risks involved.

Where investors have fixed income exposures, the ability to proactively manage those exposures through active management, as events evolve, becomes an increasingly important tool to assist in the preservation of the value of investments in both nominal and real terms.

It is likely that the next decade will be characterised by a period of lower returns and greater volatility in markets. Successful fixed income investing going forward will involve blending macroeconomic forecasts, proprietary research and company insights. Investors should not rely on market-capitalisation derived benchmark exposures for efficient capital allocation. In this environment, active management is key.

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