IMPERIUM CAPITAL

momentum

Weekly Digest

8 July 2019

Searching Further Afield

– Michael Clough

There are not many news articles I read two years ago that I can still remember. There is one though that has always stuck in my mind and it was titled 'Are we headed for a bond market bloodbath?'[1]. At the time the yield on the US 10 year Treasury was 2.5%, the UK 10 year gilt was offering an uninspiring 1.2%, whilst the German equivalent was giving you a frankly unattractive 0.4%. Today the yields in all three of these regions are below what they were in 2017. This extraordinary period of ultra-low bond yields has continued. In fact since October 2018 we have witnessed bond yields plummet further. With several high quality fixed income assets now offering negative real returns (and some even in nominal terms!), investors have had to look elsewhere and reach out for yield. Whilst the prospect of higher yielding assets is appealing in the current interest rate environment, reaching too far and taking on too much risk could come back to haunt investors.

As at the end of last week, lending money to the German government for 10 years would grant you a -0.36% annualised return. You would have to push out beyond 20 years to earn a positive return assuming you held the bond to maturity. Now, there is an Austrian government bond today which matures in 98 years time and for that time horizon you might expect quite a healthy return. The reality; a discouraging 1.1% per annum. You would have to bear over 50 years of duration risk too, so any rise in interest rates is going to be painful.

The above illustrates just how unattractive a number of typically defensive markets are today. An option for investors is to instead opt for investment grade or high yield corporate bonds. However, these are not exactly a screaming buy at current valuations. They also carry greater default risk. Whilst we do have some exposure to such credit strategies in Momentum portfolios, we have also looked at alternative opportunities available to us.

In May, we initiated a position in an asset backed securities (ABS) strategy and in June we added to a strategy investing in private infrastructure debt. Both offer attractive yields, but your first question will likely be 'Are these not adding significant risk to your portfolios?'. We don't think so. Both strategies are investing in more specialist bond sectors and provide an illiquidity yield premium, however, they are structured as closed ended investment trusts which allays the bulk of this risk. Both are managed by two focused boutique firms with vast experience managing these asset classes. We have faith in these managers to identify the most attractive opportunities in their respective markets and minimise downside risks through careful issue selection. Finally, both strategies provide exposure to principally floating rate debt. As such (rising) interest rate risk is reduced. It is important to say these strategies will never form a large part of our portfolios. As small allocations though, they give us greater diversification and introduce additional return drivers to the portfolios.

In a world of low bond yields, investors must search further afield for good value opportunities. Whilst more niche areas of the market offer better rewards they rarely come without additional risk. Our extensive due diligence process, which we subject all our managers to, has allowed us to build confidence in these newer bond strategies, but we have rejected many more in the recent past.
Now all I'm left thinking is will anyone remember reading this in two years' time. I'll live in hope. Perhaps I should have gone for a more sensationalist title instead…

[1] BBC News. 20/03/2017

The **Marketplace**

- Strong US June jobs report
- Out of 35 manufacturing PMIs, 19 fell below 50 and 27 dropped month-on-month
- Brent crude fell 3.5%, ending the week at $64.2 per barrel
- Gold prices fell 0.7% to $1399 an ounce

Market **Focus**

US

- Non-farm payrolls rose 224K, topping even the most bullish estimate of 220K. Unemployment ticked up 0.1%. The expected July 50bps interest rate cut all but priced out now but some scope still for a cut of 25bps on the back of weaker wage growth
- The US trade deficit widened by more than forecasts to 8.4% in May, a five-month high, as imports of goods surged by 3.3%
- The ISM non-manufacturing index fell to 55.1 in June from 56.9 in the previous month, the weakest pace of expansion in nearly two years
- US equities rose 1.7% on the week.

Europe

- The 10 year German Bund yield touched a new record low of -0.4%, while the yield on France's 10 year government bond fell to -0.1%, also a record low
- Euro area economic confidence fell to 103.3 points, below market expectations of 104.8 and its lowest level since 2016. The decline was primarily driven by lower industry confidence, weighed down by deepening trade tensions and a more cautious outlook for the global economy
- Thirteen EU countries reported their manufacturing PMIs on Monday, with only 5 of them reporting a value greater than 50 – the level that separates expansion from contraction
- Ursula von der Leyen and Christine Lagarde were nominated as the next presidents of the European Commission and the European Central Bank, respectively
- Continental equities advanced 1.3% on the week.

UK

- The 30-year gilt yield hit a record low of 1.42%. The previous all-time low was 1.48% in October 2016
- Bank of England governor Mark Carney is being considered to replace Christine Lagarde as the managing director of the International Monetary Fund
- A gauge of Britain's services industry – the IHS Markit/CIPS PMI – fell to 50.2 in June from 51.0 in the previous month, showing near-stagnation of the services sector
- UK equities rose 1.6% on the week

Asia/Rest of The World

- The US Commerce Department imposed duties of more than 400% on the imports of steel products produced in Vietnam using materials from Taiwan and South Korea
- China's current composite PMI is down to 50.6, compared to last month's reading of 51.5, the lowest level since October 2018
- Despite OPEC announcing a nine-month extension to production cuts, oil experienced a sharp fall this week, reversing most of the growth experienced in June
- Japanese equities performed strongly on the week, advancing 2.7%

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

Asset Class/Region	Currency	Currency returns			
		Week ending 5 July 2019	Month to date	YTD 2019	12 months
Developed Market Equities					
United States	USD	1.7%	1.7%	20.2%	10.8%
United Kingdom	GBP	1.6%	1.6%	14.8%	3.7%
Continental Europe	EUR	1.3%	1.3%	18.9%	6.5%
Japan	JPY	2.7%	2.7%	8.0%	-2.7%
Asia Pacific (ex Japan)	USD	0.8%	0.8%	13.1%	3.2%
Australia	AUD	2.0%	2.0%	22.1%	13.4%
Global	USD	1.3%	1.3%	18.5%	7.3%
Emerging markets equities					
Emerging Europe	USD	1.5%	1.5%	22.2%	15.1%
Emerging Asia	USD	0.5%	0.5%	10.2%	0.3%
Emerging Latin America	USD	2.4%	2.4%	15.3%	19.9%
BRICs	USD	1.5%	1.5%	15.5%	6.7%
MENA countries	USD	0.7%	0.4%	9.7%	7.3%
South Africa	USD	-1.5%	-1.5%	9.7%	-3.4%
India	USD	0.8%	0.8%	11.2%	11.6%
Global emerging markets	USD	0.7%	0.7%	11.3%	3.2%
Bonds					
US Treasuries	USD	-0.3%	-0.3%	5.1%	7.0%
US Treasuries (inflation protected)	USD	-0.2%	-0.2%	6.2%	4.3%
US Corporate (investment grade)	USD	-0.1%	-0.1%	9.8%	10.3%
US High Yield	USD	0.3%	0.3%	10.2%	7.8%
UK Gilts	GBP	1.3%	1.3%	6.3%	6.3%
UK Corporate (investment grade)	GBP	1.2%	1.2%	8.2%	7.7%
Euro Government Bonds	EUR	0.8%	0.8%	6.8%	7.1%
Euro Corporate (investment grade)	EUR	0.4%	0.4%	5.9%	5.2%
Euro High Yield	EUR	0.7%	0.7%	8.5%	5.8%
Japanese Government	JPY	0.2%	0.2%	3.1%	3.3%
Australian Government	AUD	0.2%	0.2%	8.1%	11.4%
Global Government Bonds	USD	-0.4%	-0.4%	4.9%	4.9%
Global Bonds	USD	-0.4%	-0.4%	5.2%	5.2%
Global Convertible Bonds	USD	0.2%	0.2%	7.7%	3.0%
Emerging Market Bonds	USD	0.7%	0.7%	11.5%	11.4%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 5 July 2019	Month to date	YTD 2019	12 months
Property					
US Property Securities	USD	2.4%	2.4%	19.9%	10.8%
Australian Property Securities	AUD	6.7%	6.7%	24.5%	20.3%
Asia Property Securities	USD	2.3%	2.3%	15.4%	13.1%
Global Property Securities	USD	2.3%	2.3%	17.6%	9.9%
Currencies					
Euro	USD	-1.2%	-1.2%	-2.0%	-4.1%
UK Pound Sterling	USD	-1.4%	-1.4%	-1.8%	-5.4%
Japanese Yen	USD	-0.6%	-0.6%	1.0%	1.9%
Australian Dollar	USD	-0.5%	-0.5%	-1.0%	-5.6%
South African Rand	USD	-0.5%	-0.5%	1.5%	-4.5%
Swiss Franc	USD	-1.6%	-1.6%	-1.0%	0.0%
Chinese Yuan	USD	-0.4%	-0.4%	-0.2%	-3.6%
Commodities & Alternatives					
Commodities	USD	-0.8%	-0.8%	6.8%	-6.3%
Agricultural Commodities	USD	-0.7%	-0.7%	-1.8%	-6.0%
Oil	USD	-3.5%	-3.5%	19.4%	-17.0%
Gold	USD	-0.7%	-0.7%	9.2%	11.3%
Hedge funds	USD	0.6%	0.6%	4.9%	-1.6%

Source: Bloomberg. Past performance is not indicative of future returns

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