Falling interest

Weekly Digest

16 July 2018

– *Andrew Hardy, CFA*

Investment managers have significantly reduced allocations to corporate bonds in their portfolios over the past year. This isn't because they expect an imminent downturn, but instead reflects the asymmetric profile they see from these levels with very little upside potential and meaningful downside risk.

In a few weeks the Bank of England (BOE) is widely expected to increase interest rates, for only the second time in the last decade. The US Federal Reserve is considerably further down the line having already made seven increases in the past three years; at some point the BOE may need to play catch-up. Political uncertainty in the UK has been holding the economy and interest rates back but with economic data rebounding recently it is now highly likely that rates will be above the current level of 0.5% by the end of the year. The Eurozone is likely to be in a similar position next year.

The recent era of ultra-low interest rates and quantitative easing (QE) has been painful for those reliant on income from their savings. However, those with holdings in fixed income securities have probably benefited from an offsetting increase in the capital value of their portfolio (since falling interest rates increases the price of fixed yield bonds). The risk is that this process may be beginning to move into reverse, albeit slowly. Investors are likely to begin seeing higher yields and distribution rates on their investments but capital values may fall if interest rates move up faster than expected.

In the UK, corporate bond funds represent one of the largest fund categories according to Investment Association data, with assets under management of £70 billion as of May 2018. This category is equally swollen (if not more so) outside of the UK and is one of the areas where the risk of disappointment is arguably greatest over the next few years. The current sterling corporate bond index yield of below 3% barely compensates investors for the current inflation rate, let alone any risk that inflation moves higher from here or for future defaults. Furthermore, the credit quality behind corporate bond yields has deteriorated in recent years as companies have taken advantage of low interest rates by increasing borrowing, leaving them with lower quality balance sheets and somewhat higher default risk.

Despite interest rates being at rock bottom levels for most of the last ten years, the sterling corporate bond index has returned 7% per annum. This will not be the case for the next ten years, especially if base rates move anywhere close to the highs of the last cycle of 5.75%. We do not expect this but the point is that the risks are asymmetric from this point. The pricing of European corporate bonds makes even less sense with yields below 1% still, driven by the European Central Bank's QE programme.

Those in need of a steady income stream should consider a portfolio that is well diversified across different asset classes. There are many other investments that can improve the overall yield of a portfolio whilst arguably reducing the risk profile through diversification. This would include emerging market bonds, asset backed securities, listed property or infrastructure or even high quality equities. Each carry their own risks in isolation but we believe a carefully assembled portfolio would be much more robust in a range of scenarios than an overvalued corporate bond portfolio at this point.

The **Marketplace**

- Brent crude fell 3% to $74.9 a barrel
- Gold fell 1% to $1242 an ounce
- European stocks rose, commodities fell
- US Treasury yield rose just 0.5bps in a very quiet week for bond markets

Market **Focus**

US

- The Dow Jones rose 0.4% to end the week at 25,019
- US core CPI reading was +0.2% month on month in line with expectations.
- The Nasdaq 100 rose 2.3% to 7375.9
- The S&P index rose 1.5% to 2801 and had its longest rally in a month over the last week

UK

- The government have published a white paper outlining details of a softer approach to Brexit. The key part is the proposal of a new free trade area where the UK follows EU standards. We can expect a lot of pushback from the Eurosceptic wing of the party
- UK GDP increased 0.2% over the last three months
- The FTSE 100 rose 0.6% to end the week at 7661.9

Europe

- Germany's June CPI came in at +2.1% yoy whilst France's CPI was 2.3% yoy
- President Trump indicated that he expects allies to up their defence budgets at an emergency NATO meeting. He also made a visit to the UK and will meet with President Putin in Helsinki today
- The Euro Stoxx 50 had a relatively flat week, ending the week up 0.2% at 3454.5

The rest of the world

- China's GDP reading for the second quarter was in line with expectations at 6.7%. A fundamentally solid picture has still seen a slight slowdown
- China to retaliate in the trade war and urging other to follow suit -they are due to lodge a complaint with the WTO. The US is set to target another $200bn in goods
- The Hang Seng index rose 0.7% to 28,525
- The Nikkei 225 rose 1.9% to 22,597.

Past performance is not indicative of future returns.

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

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Asset Class/Region	Currency	Currency returns			
		Week ending 13 July 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	1.5%	3.1%	5.5%	16.0%
United Kingdom	GBP	0.6%	0.3%	1.7%	7.0%
Continental Europe	EUR	0.7%	1.8%	0.4%	0.8%
Japan	JPY	2.3%	0.0%	-3.7%	9.1%
Asia Pacific (ex Japan)	USD	1.4%	0.5%	-3.7%	7.6%
Australia	AUD	-0.1%	1.2%	5.5%	14.1%
Global	USD	1.0%	2.2%	2.6%	12.3%
Emerging markets equities					
Emerging Europe	USD	-0.4%	1.6%	-6.9%	4.6%
Emerging Asia	USD	1.9%	0.3%	-4.8%	7.3%
Emerging Latin America	USD	2.2%	4.2%	-7.5%	-1.6%
BRICs	USD	2.0%	1.0%	-3.7%	11.9%
MENA countries	USD	1.4%	1.2%	10.2%	8.8%
South Africa	USD	0.4%	2.0%	-13.9%	6.3%
India	USD	2.8%	2.9%	-1.5%	6.3%
Global emerging markets	USD	1.7%	1.0%	-5.8%	5.7%
Bonds					
US Treasuries	USD	0.0%	0.3%	-0.9%	-0.2%
US Treasuries (inflation protected)	USD	0.0%	0.4%	0.4%	2.8%
US Corporate (investment grade)	USD	0.4%	0.9%	-2.4%	0.1%
US High Yield	USD	0.5%	0.5%	0.7%	3.0%
UK Gilts	GBP	-0.1%	0.1%	0.5%	2.6%
UK Corporate (investment grade)	GBP	0.2%	0.3%	-1.5%	0.9%
Euro Government Bonds	EUR	0.2%	0.3%	0.8%	2.5%
Euro Corporate (investment grade)	EUR	0.3%	0.4%	-0.2%	1.3%
Euro High Yield	EUR	0.5%	1.2%	-0.6%	1.9%
Japanese Government	JPY	0.0%	0.2%	0.9%	1.6%
Australian Government	AUD	0.1%	0.1%	2.0%	3.3%
Global Government Bonds	USD	-0.5%	-0.1%	-1.0%	2.1%
Global Bonds	USD	-0.3%	0.2%	-1.3%	1.8%
Global Convertible Bonds	USD	0.0%	0.1%	0.0%	2.1%
Emerging Market Bonds	USD	0.5%	2.0%	-4.2%	-2.4%

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

IMPERIUM CAPITAL

momentum

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Asset Class/Region	Currency	Currency returns			
		Week ending 13 July 2018	Month to date	YTD 2018	12 months
Property					
US Property Securities	USD	-0.9%	1.0%	1.5%	4.4%
Australian Property Securities	AUD	0.4%	2.1%	2.4%	12.4%
Asia Property Securities	USD	0.1%	-0.5%	-3.2%	6.8%
Global Property Securities	USD	-0.4%	0.4%	-0.5%	7.6%
Currencies					
Euro	USD	-0.6%	0.0%	-2.9%	2.5%
UK Pound Sterling	USD	-0.4%	0.2%	-2.3%	2.3%
Japanese Yen	USD	-1.7%	-1.5%	0.1%	0.8%
Australian Dollar	USD	-0.2%	0.2%	-5.2%	-4.1%
South African Rand	USD	1.7%	3.6%	-6.7%	-0.4%
Swiss Franc	USD	-1.3%	-1.1%	-2.9%	-3.4%
Chinese Yuan	USD	-1.3%	-1.6%	-3.2%	0.8%
Commodities & Alternatives					
Commodities	USD	-2.2%	-3.2%	2.3%	14.8%
Agricultural Commodities	USD	-2.4%	-1.7%	-2.4%	-7.2%
Oil	USD	-2.3%	-5.2%	12.7%	55.6%
Gold	USD	-1.1%	-1.1%	-4.9%	2.0%
Hedge funds	USD	0.4%	0.7%	-0.1%	2.7%

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