Bond Life Weekly Digest

26th August 2016

Strategy

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Over the last couple of weeks, we have written about the possible strategic shift that is coming which could be the end to the long term bull market for bonds. Essentially it rests on the notion that monetary policy has run its course and increasingly we will see fiscal stimulus leading the way and the increase in debt coupled with higher inflation will push government bond yields higher. The two countries that could attempt versions of this first are the UK (in response to the Brexit shock) and Japan. The UK looks like the country that may be better positioned to benefit from a dose of government funded infrastructure spending. It is reluctant to push rates into negative territory but the effects on pension funds from the very low gilt yields are enough to suggest an alternative plan may be tried. Elsewhere there may have to be a further leg down in economic prospects before the fiscal flood gates are open? Do they need a version of Brexit shock before we see a change? After all, in the US they are still contemplating raising rates and Europe seems to have survived a potential Italian banking crisis and lending is picking up in response to low rates.

One event that could prove to be a catalyst could be the impending Italian referendum on constitutional reform. There are other areas of political stress in Europe (see table below) but this may be the most critical.

Country	Election	Date	Result/Comments
UK	EU Referendum	June 23rd 2016	52% voted to leave the EU
Spain	Parliamentary	June 26th 2016	Hung parliament, incumbent party increased share of votes
Austria	Presidential	October 2nd 2016	May '15 result overturned due to voting irregularities
Hungary	Migration Referendum	October 2nd 2016	To accept EU rules on migrant settlement
Italy	Constitutional Referendum	October 2016	Reform of the Senate
Netherlands	Parliamentary	By March 2017	
France	Presidential	April/May 2017	
Germany	Federal	September 2017	

The concern is that the Italian Prime Minister has said he will resign as leader if he loses and given the level of dissatisfaction with the establishment (not just in Italy) then, regardless of the merits of the reform, it is turning into a vote on the status quo. The resultant general election could then turn into a vote on Euro membership. According to opinion polls the Italians want to stay in the Euro (but what do they know) but after several years of

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poor wage growth and low employment the benefits of the Euro are harder to see and the desire for change may outweigh any logic.

The markets have not focussed on this risk and are still responding positively to the fact that the banking system hasn't collapsed and the ECB is supporting the bond markets. Unlike the UK the European authorities are not showing a general willingness to make a change beyond allowing government deficits to slip. Perhaps they need a reason.

Strategy implications: -

Before we call and end to the Bond Bull market and position for a proper Bear phase (beyond just a tantrum, see last week's note for a description of the difference) we should be satisfied that the Euro isn't about to fall apart and that the Chinese economy isn't going to collapse into a credit crunch. The next few months are likely to be very volatile for bonds.

In addition to focussing on markets where monetary policy is still supportive of bond markets (Australia, New Zealand) we own US Tips, credit and a slightly increased EM sovereign exposure. We are underweight the Gilt market and have increased our hedges against higher US rates by buying US 10yr bond puts. The US bond market has had a very quiet August despite stronger employment data and selective Fed hawkishness. We are happy to hold US duration given the yield spread over the rest of the world but feel it appropriate to add to protection over the key central bank gathering this week and the impending US election.

Overall duration has come down a tad to 3.5 (from 3.8) in the Global Dynamic fund.

Currencies

We continue to tweak our currency scorecard and it has helped with some interesting pointers. The latest version

Currency snapshot

Developed Markets 24/08/2016	2 YR INT RATES VS AVG	FISCAL & C/A change over last 6mths	POLITICS of election and central bank attitude	MACRO VULNERABILITY 5yr CDS 3m moving average	MKT POSITIONING M S. If o/w then its neg	VALUE BIS REER VS 200 DMA	TECHNICAL SCORE 1PT PER SCALE	SCORE	CURRENT POSITION	COMMENTS	TECHNICALS MACD/RSI	STRATEGIC VIEW	
USD	0.78	-1	-1	2	4	-1	1	6.3	LONG	ABOUT RISK BUT INT RATE EXPECTATIONS WILL BE MAIN DRIVER	BUY/N↑	SHORT	USD
EUR	-0.62	0.5	-3	1	-1	2	-2	-5.0	SHORT	FOLLOWING OIL, ITALIAN REF A CONCERN	SELL/SELL↓	N	EUR
JPY	-0.18	2.5	0	-2	-3	3	-1	-1.5	N	LONG TERM TREND HIGHER UNLESS BOJ DOES SOMETHING SPECIAL	SELL/N↓	LONG	JPY
GBP	0.14	0	2	-3	6	2	0	9.6	N	BREXIT CONCERNS NEAR TERM, CHEAP LONG TERM	N/N↓	LONG	GBP
CHF	-0.96	0.5	0	0	3	-2	0	0.2	N	n/a		N	CHF
CAD	0.59	-1.5	1	0	-7	2	-1	-9.0	SHORT	OIL AND PROPERTY BUBBLE CONCERNS	SELL/N↓	LONG	CAD
AUD	1.44	0.5	-1	0	-5	1	0	-4.9	LONG	CHEAPER THAN NZD	N/N↑	LONG	AUD
NZD	1.79	0.5	-1	-1	0	-1	-2	-4.4	SHORT	CB NEG ON CURRENCY	SELL/SELL↓	N	NZD
NOK	0.55	-3	1	3	0	3	-1	4.5	N	want to buy but watch OIL! Misssed it!!	SELL/N	LONG	NOK
SEK	-0.64	1	1	0	1	2	-1	4.2	N	ECONONMY RESPONDING TO LOW RATES	SELL/N↓	LONG	SEK

is below. If anyone is interested in the methodology, please see Trevor and I.

Some interesting results. Sterling is coming up as the best currency to buy right now given how short the market is and the commodity currencies are a sell. The technical position has moved positive for the USD and we are keeping a close eye on the EM currencies as they are rolling over and maybe pointing to a period of stress.