June 2017 Update

And here's to you Mrs Robinson.

When my information changes, I alter my conclusions. What do you do, sir? Keynes

Well Mrs Wilkins actually. Who is Mrs Wilkins? Given some of my brokers on the 12th of June were referring to Wilkins as a he rather than a she, I guess a few people were asking that question. She is Senior Deputy Governor Carolyn Wilkins of the Bank of Canada. (BOC)

Why am I toasting her? Because she was the first central banker outside of the US to talk about a rate hike relatively soon.[1]

An important aspect of our inflation assessment is that the <u>economic drag from lower oil prices is now largely behind us</u>. And the 50 basis point reduction in our policy rate in 2015 has facilitated this adjustment. As growth continues and, ideally, broadens further, <u>Governing Council will be assessing whether all of the considerable monetary policy stimulus presently in place is still required</u>. (my underscore)

It sounds relatively innocuous, but as signalling goes, it was large. She was followed the next day by her boss, BOC Governor Poloz agreeing, and suddenly the Canadians are sure rates will be hiked not once this year but twice! You couldn't find an economic forecaster suggesting a rate hike before mid-2018 just a month ago. (Sound familiar to the Australians?) Indeed the chart below shows that the market now expect 0.44% in rate hikes before the end of this year, compared to 0.05% before Carolyn Wilkins spoke.

[1] Remarks by Carolyn A. Wilkins, Senior Deputy Governor of the Bank of Canada, The Associates of the Asper School of Business Winnipeg, Manitoba 12 June 2017. Yes other central bank members in the UK have talked of rate hikes (see later), but as an individual view. She was talking as a bank view.

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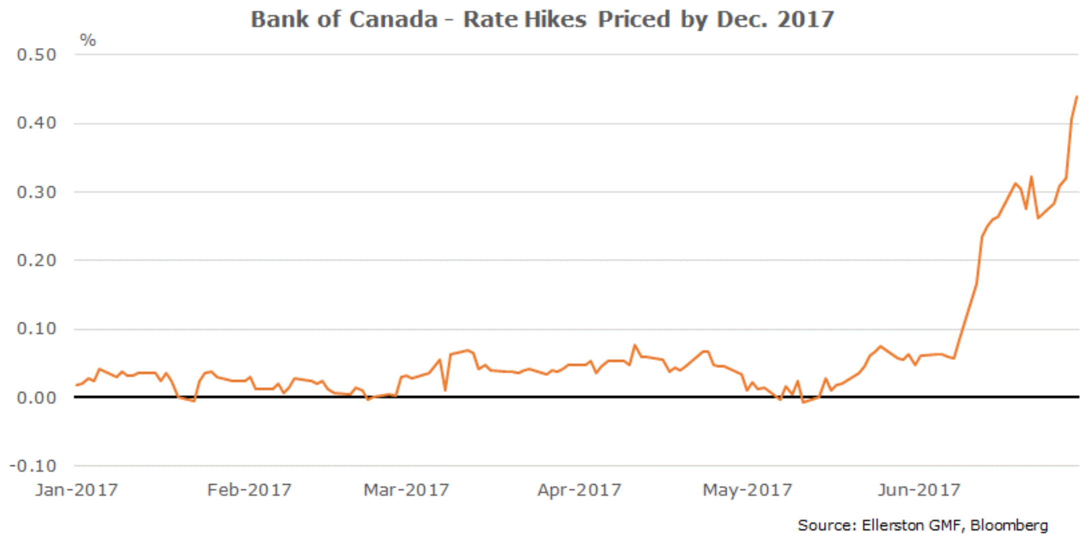
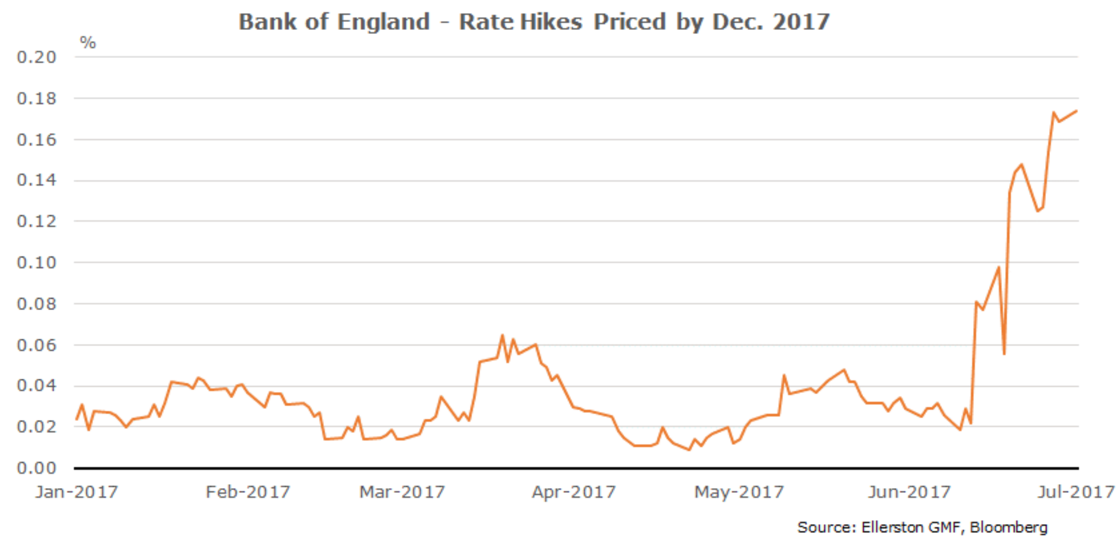


What has been fascinating about June, is that she was followed by similar hawkish overtures from the Bank of England (BOE)[2] and even the European Central Bank (ECB). Suddenly all are singing from the same hymn book…and it is probably not a coincidence. They talk.

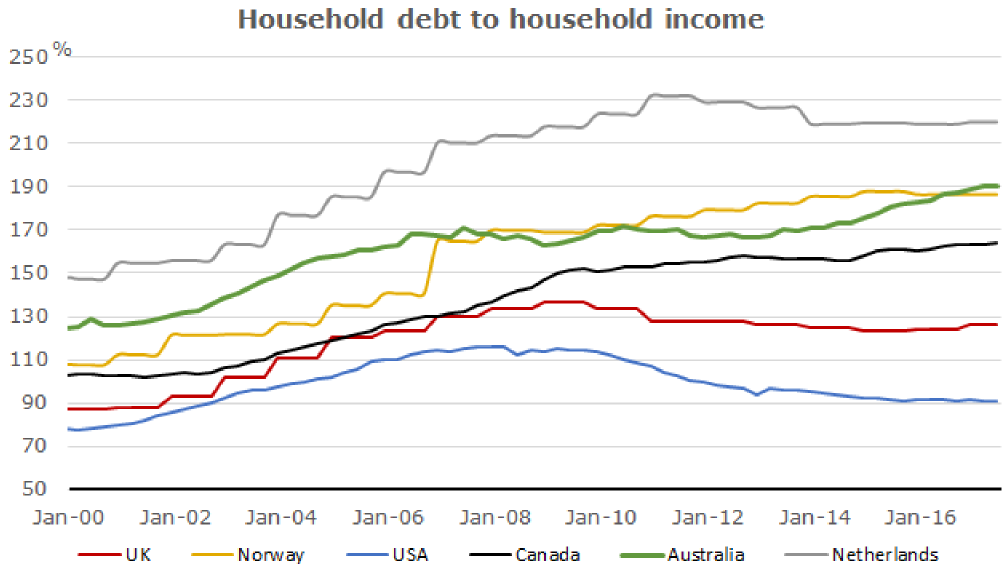
Pricing in the UK moved from an expected 2bp rise this year to 17.



And so June ended with fevered discussions of global rate hikes, and a little unease in equity markets.

But why am I toasting anyone who talks about rate hikes? Surely that is a scary thing no? Won't housing markets collapse? Won't equity markets collapse? After all, look at the debt picture. In Australia, household debt divided by income is 190%. Gulp. Second highest in the world after the Netherlands. Surely this will end badly?

[2] BOE surprised the market by voting 3-5 to hike rates at its June 15th Monetary Policy meeting. It was followed by Haldane speech suggesting he would vote for a hike soon (Work, Wages and Monetary Policy Speech given by Andrew G Haldane Chief Economist, Bank of England National Science and Media Museum, Bradford 20 June 2017) and Forbes criticising the BOE for not hiking (Failure to launch Speech given by Kristin Forbes, External MPC Member, Bank of England London Business School 22 June 2017.) This is a must read!

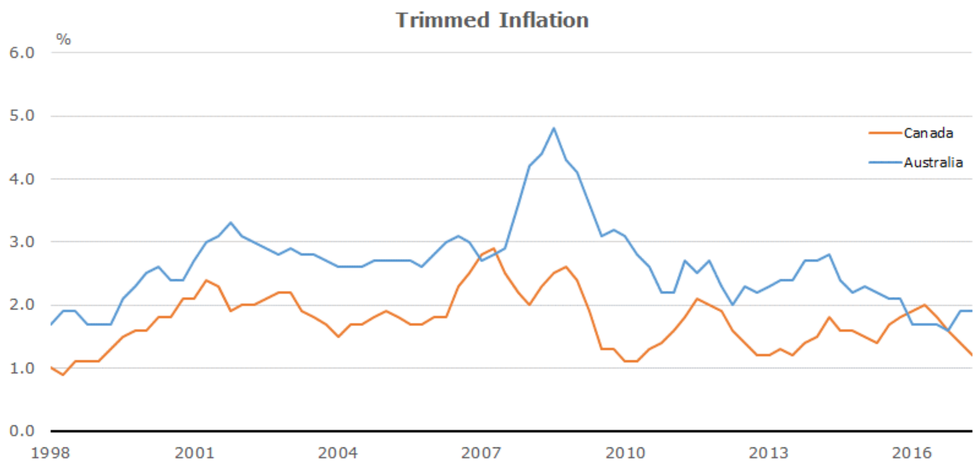


Source: Eurostat, Bloomberg, Ellerston GMF

Well there is one surely. It will surely end badly if asset markets continue to get propped up by cheap money.

But the good news, the really exciting news for me, is finally it seems central banks are taking financial stability – aka bubble risk – into account.[3] The surest way to safeguard the housing market is to stabilise the debt to income ratio (if not lower). And the surest way to do that is modest rate rises. It also happens to be the time when discretionary global macro performance shines, relative to other asset classes.

Interestingly, a dogmatic adherence to the inflation target in Canada would not allow a rate hike. Trimmed inflation is only 1.2% (v 1.9% in Australia)



Source: Ellerston GMF, Bloomberg

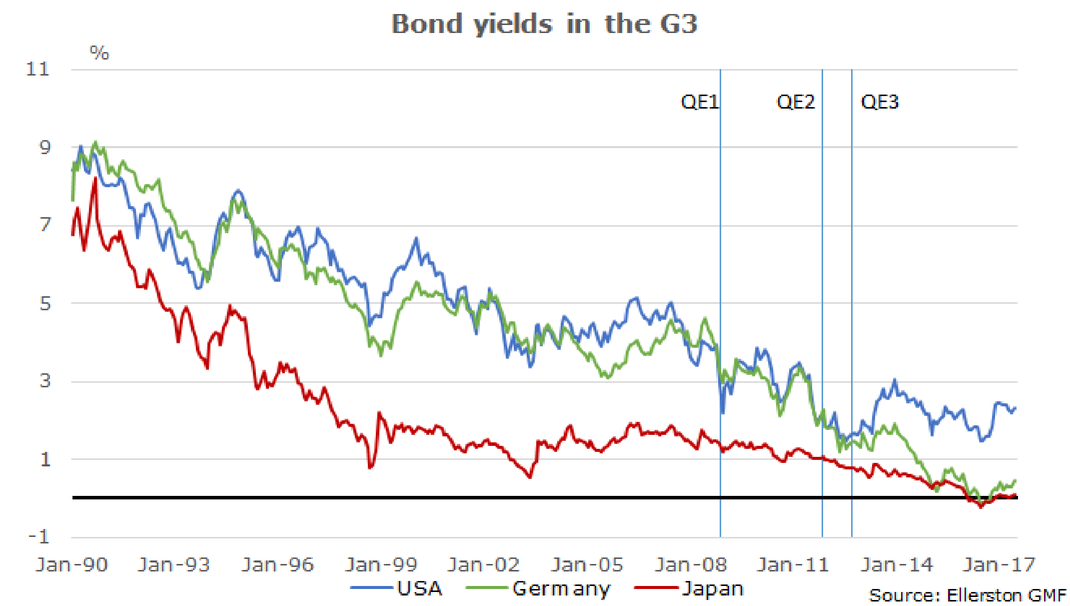
Indeed, the same has many suggesting the Fed won't continue to hike. Or Europe won't hike for years. Most forecasters find it difficult to see rate hikes, because they find it difficult to see inflation.

[3] *The RBA has always factored debt levels into their policy decisions. But the Fed refuses to. In hiking in Nov 2003, the RBA said "The prevailing stance of policy has been expansionary, as is clear not only from the current low level of nominal and real interest rates, but also from the behaviour of borrowers. Credit outstanding is rising at around 14 per cent per year, and at over 20 per cent to households. That is a much faster rate of growth than can be expected to be consistent with economic stability over the longer run. Short periods of rapid credit growth have not typically been a major concern for monetary policy, but this growth has been sustained for some time and at present shows no sign of abating."* The RBA leant against a debt build up prior to the GFC and is a key reason why Australia has achieved the longest growth period in history of any economy.

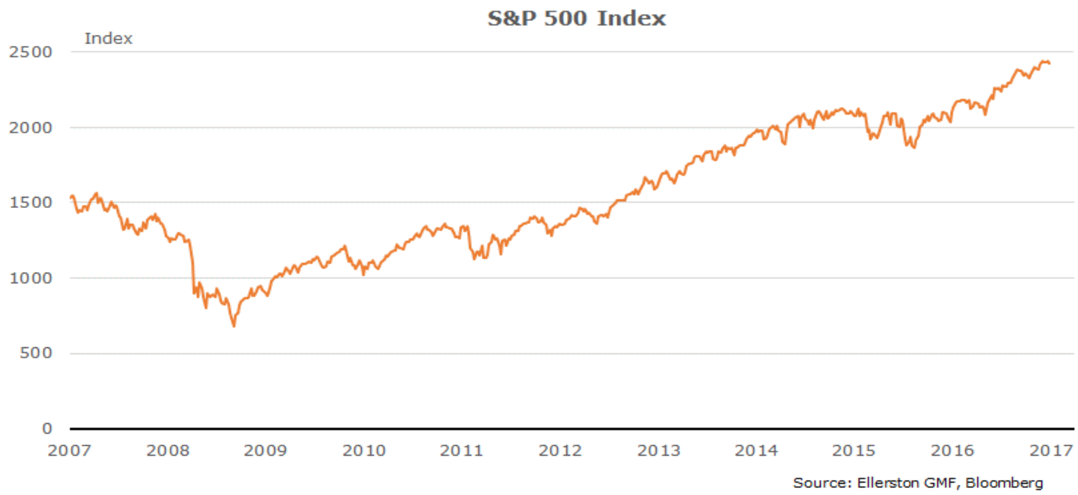
I concur on the latter. But not the former. And it seems the central banks are now making it pretty clear they are of the same mindset. In essence they are saying, growth and employment are good, the economies have healed, let's move interest rates back to less extreme levels before we create another bubble. Despite central banks targeting inflation, they have always had more flexibility than many people realise.[4]

Is this big news? If you are an investor, yes.

What has happened since the financial crisis in asset markets? Eye watering central bank accommodation (negative interest rates and quantitative easing, unfathomable a decade ago and unprecedented in history) has driven bond yields to record lows (and we are talking 300 years of history in the UK!)



And in turn equity prices in the US 300% off their lows.

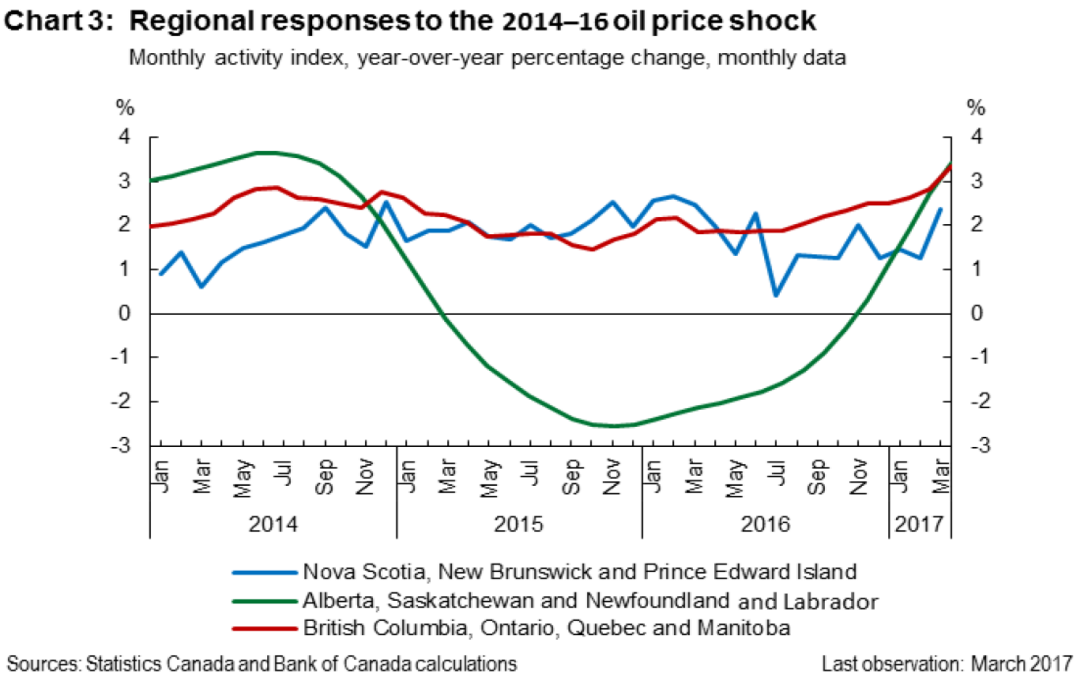


The newspapers in Australia at the end of the financial year are full of glowing reviews of the returns of superannuation funds since the crisis. As I outlined in my "I should be so lucky" note, returns of balanced funds and the so called risk parity trades has been purely a function of

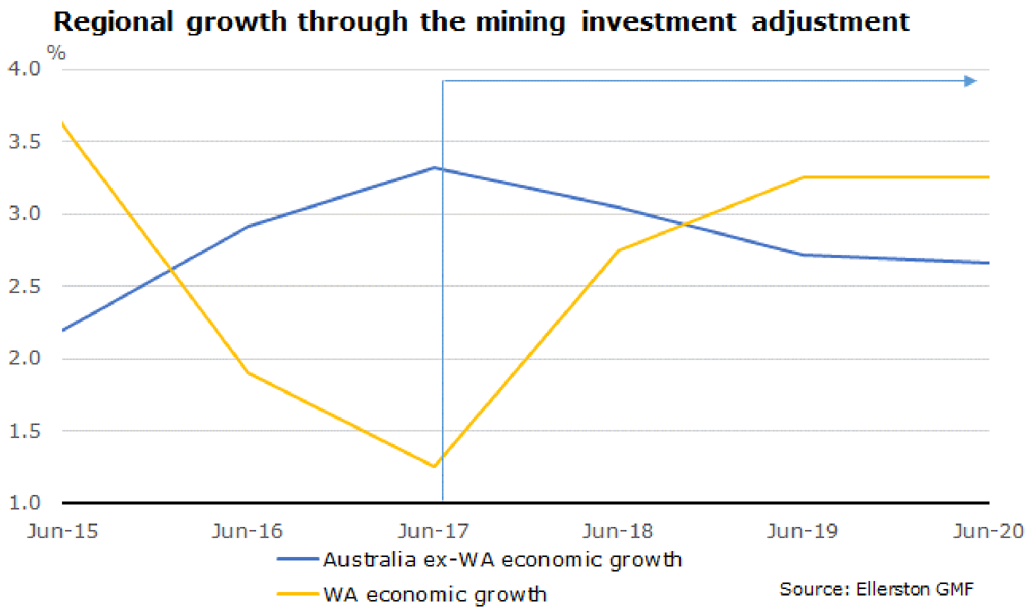
[4] This is because the policy settings today are based on their forecasts in 2-3 years' time. So if they are getting more concerned about asset bubbles, they can hike rates today based on a forecast that inflation will return to target in 2-3 years, even if they are not overly confident of the latter. The balance of risks approach. Some central banks have been better at this than others…

central banks. History could view June 2017 as the month central banks rang the bell. (In case you haven't read my prior notes, that is the bell to get out of funds that have benefitted from global easing – balanced funds, credit funds and risk parity funds – and into funds that traditionally perform when central banks move rates, namely discretionary global macro funds) https://ellerstoncapital.com/wp-content/uploads/Global-Macro-Newsletter-April-2017.pdf

Could the RBA do the same as the BOC and talk of rate hikes soon? We think the analogies are striking. The reason for the switch in Canada was the recovery in the oil sector.



We forecast the same recovery occurring in our mining sector.



Indeed RBA Governor Lowe said in May;

Over recent years, the low interest rates in Australia have helped the economy adjust to the *<u>winding down of the mining investment boom</u>. They have helped support employment and demand through a significant adjustment in the Australian economy. We should not, though, expect interest rates always to be this low.* (My underscore)

Will the RBA return to explicitly leaning against increasing debt as they did in 2003?

Well Governor Phillip Lowe explicitly addressed the idea of targeting debt levels in the same speech in May;[5]

I want to make it clear that the Reserve Bank does not have a target for the debt-to-income ratio or the ratio of nationwide housing prices to income.

As I spoke about earlier, there are good reasons why these ratios move over time. My judgement, though, is that, in the current environment, the resilience of our economy would be enhanced by an extended period in which housing prices and debt outstanding increased no faster than our incomes. Again, this is not a target or a policy objective of the Reserve Bank, but rather a general observation about how we build resilience.

Not a target, but the resilience of the economy would be enhanced…Who would not want to enhance the resilience of the economy given the opportunity? We expect the RBA to hike rates early in 2018, possibly even earlier.

What does it mean for investors? As I have been writing for the last few months, we are now entering a global phase of *normalisation* for interest rates. The risk parity trade (and balanced fund out-performance) is over. The only question now is will it be orderly, or disorderly? The uniform global central bank turn in June has raised the odds of an orderly normalisation. Marginally…

So what should an investor do? You can hope that asset markets respond in an orderly fashion to the global normalisation of interest rates and balance sheets.

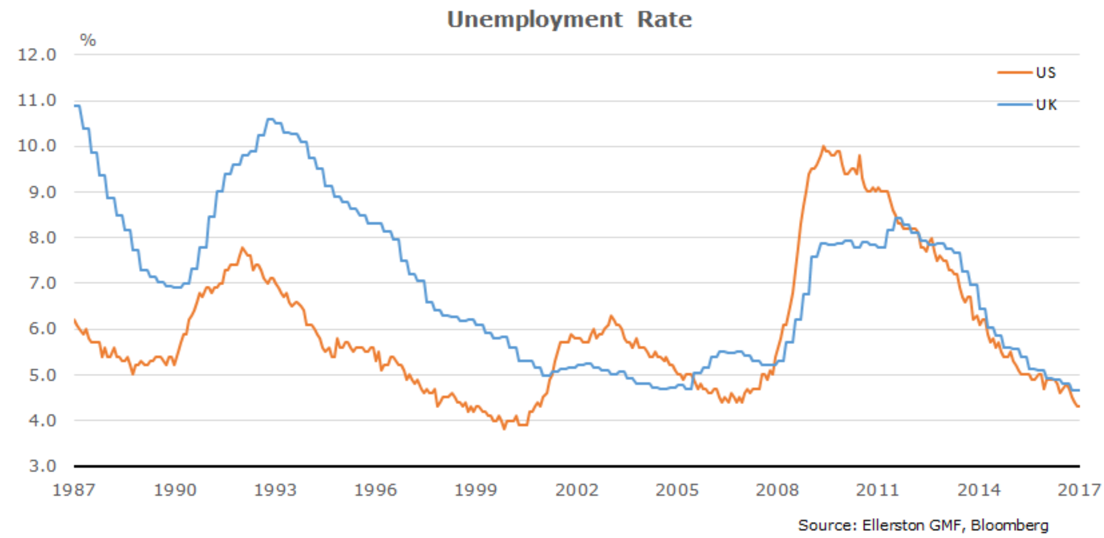
Hope?

[5] Economic Society of Australia (QLD) Business Lunch Brisbane – 4 May 2017

We can hope for the best. But hope shouldn't be in your portfolio.

The only thing we can be confident about is that the process of normalisation has started, and cash rates globally are going up. That is the largest position in our portfolio.

Yes central bank rate rises may still be too late to control wages and inflation. After all unemployment rates in the US and UK are already at or near 30 year lows. And this is now clearly in the balance of risks assessment of the BOE and Fed.



So I am encouraged, dare I say seduced, by the central banks turn in June. Maybe, just maybe, they will extricate themselves from this debt fuelled mania without another crisis.

Brett Gillespie

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