Free your mind and the rest will follow

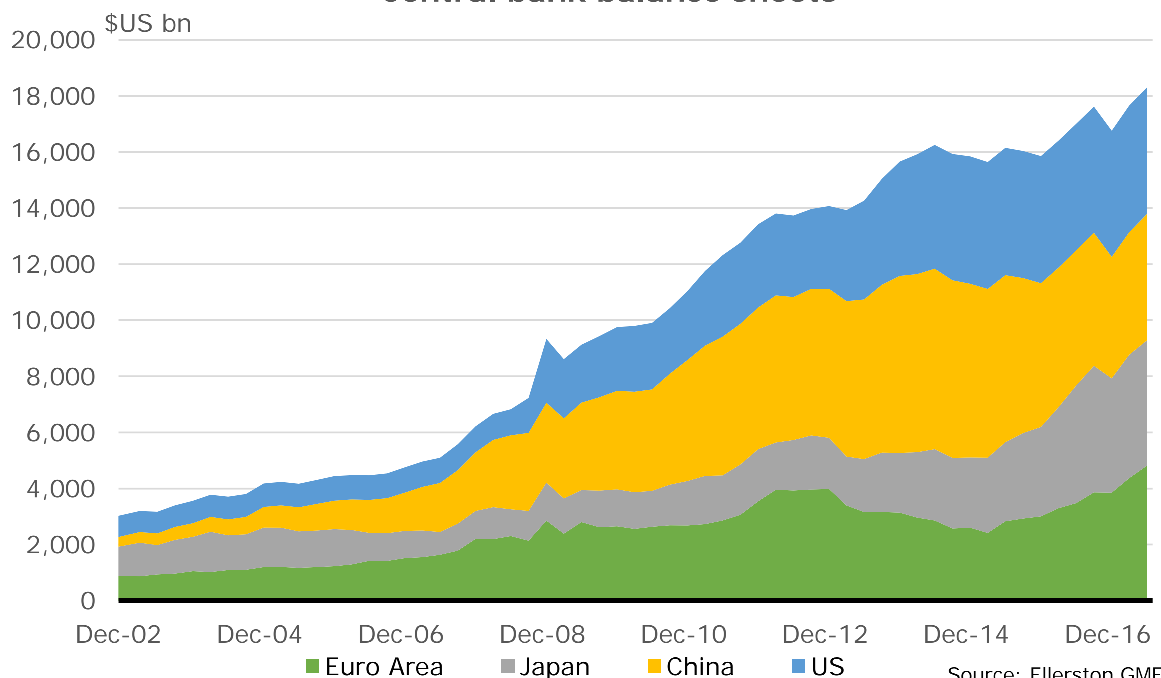
Wisdom consists of the anticipation of consequences. - Norman Cousins

Would you ring up the insurance company to insure your house after it has burnt down? Probably not… Well okay, perhaps after you have rebuilt it and learnt your lesson.

What about if you have never been insured and you lived near the bush. Would all the current warnings about the driest winter on record, with record fuel build up, encourage you to insure? Or at least go out and buy a diesel fire pump? Clean your gutters?

Those that make no preparation, or take insurance, particularly when they have been warned, tend not to get a lot of sympathy. And rightly so.

So have you heard all the talk about global central banks hiking? And unwinding their balance sheet purchases?



Is it a little too hard to understand? Like global warming? Isn't it easier to just ignore – take no preventative action or insurance? Or is your portfolio diversified enough already – that's your insurance?

Well I have presented at three investment conferences in the last month, and I would make a couple of observations;

1. Most Mum and Dad investors don't understand what low interest rates and quantitative easing has done for their portfolios
2. Most professional advisors do, but are still trying to work out how to protect their portfolio without compromising performance.

Related to that last point, I've learnt two things;

1. Investors are very skeptical about the ability of any manager to add value.
2. Many investors don't understand how a global macro fund works.

Was I surprised? I guess I was a little. After all, these were conferences for financial planners, investment professionals and academics. Not Mums and Dads. But the reality is that most Australian investors have had zero exposure to global macro investing.

Re managers outperforming, where do you start? It has been a raging debate in Australia since the late 90's. But let me make one observation;

Understand the motivation of your portfolio manager.

Is he motivated to accumulate assets?

Or is he motivated to perform for his clients?

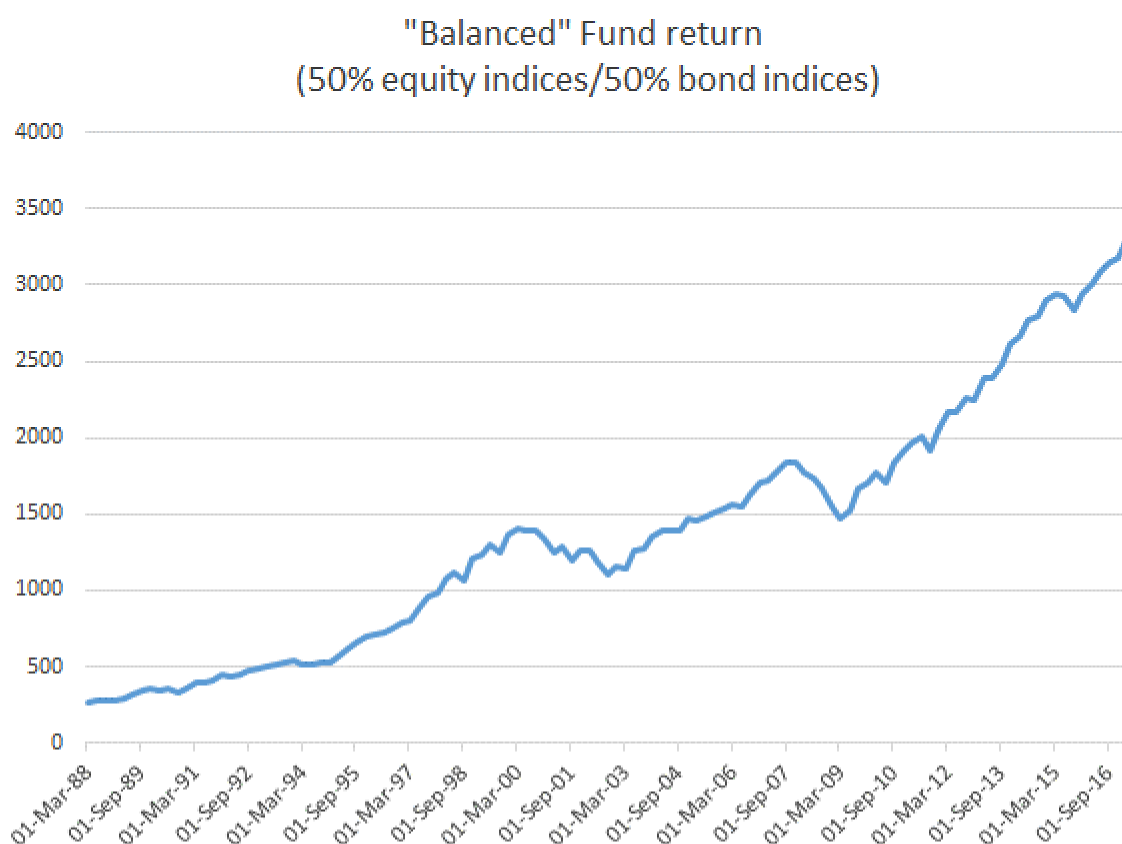
If it is the former, the worst thing he can do is underperform. There is no surer way to lose assets. But fear of underperforming leads to fear of taking risk, and hence benchmark performance.

If it is the latter, the worst thing your manager can do is not perform. Indeed, a hedge fund trader typically only gets paid if he/she outperforms enough to cover costs. Even their salary is advanced against future earnings. Like a tennis professional, no win, no money – at all![1]

Why is this important? Because most of the frustration I was hearing is about "traditional" asset managers, who I put in the accumulation class. After all, with a flow of 9.5% of all salaries coming into superannuation funds each year, all they want to do is make sure that flow continues.

I was ruminating over this after I answered questions following a presentation I did at the end of September[2]. One person was convinced no manager could out-perform over the long term (50 years in his mind!) But he seemed to know very little about global macro. Another suggested that whilst he was convinced by my arguments, he still felt reluctant to pull the trigger and invest. What could I say to get him over the line? In the interest of getting a laugh, I suggested he would likely do what most investors do, and chase returns. But what I should have said is can you afford not to do something? The warnings are loud and clear. Don't you need some protection?

What I presented was my "I should be so lucky" letter from April. For those who haven't read it, I argued that balanced funds (and risk parity funds) have had spectacular performance due to global quantitative easing, and this is now set to reverse. Investors need to consider how their portfolios will perform if yields rise, particularly if they rise quickly, which is a distinct possibility.



So will they?

Well what yields are we talking about? The Fed's overnight rate? Or the US 10 year rate? Both?

[1] There are problems with the way hedge fund managers are remunerated as well, where traders are arguably incentivized to "have a swing" if they are deeply negative. But retained bonuses and bonuses linked to fund growth can navigate that

[2] IMR Program Conference, University of Technology - Sydney

Let's tackle the Fed's overnight rate first. The probability of a Fed hike in December jumped this last month, from 28% to 64%.

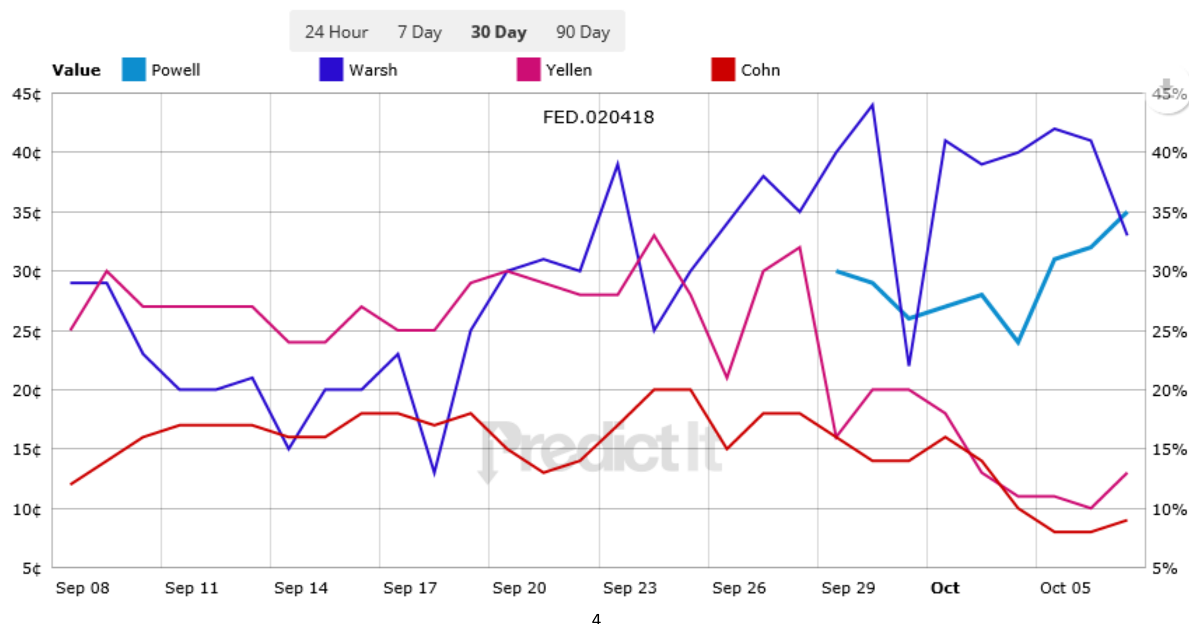
Why? Because in essence Yellen said so.

…without further modest increases in the federal funds rate over time, there is a risk that the labor market could eventually become overheated, potentially creating an inflationary problem down the road that might be difficult to overcome without triggering a recession. Persistently easy monetary policy might also eventually lead to increased leverage and other developments, with adverse implications for financial stability. For these reasons, and given that monetary policy affects economic activity and inflation with a substantial lag, it would be imprudent to keep monetary policy on hold until inflation is back to 2 percent.[3]

For central bank observers, the transition in Yellen was decisive. She confirmed she is and has always been a labour market economist. That means she believes in the so-called Phillips curve, that falling unemployment will eventually create wage and price pressures.

[3] September 26, 2017 *Inflation, Uncertainty, and Monetary Policy* Chair Janet L. Yellen. At the "Prospects for Growth: Reassessing the Fundamentals" 59th Annual Meeting of the National Association for Business Economics, Cleveland, Ohio

Okay so that makes December fairly clear. But what about next year. After all, Yellen leaves in February, so what does it matter what she thinks now? Perhaps not. But she has set the sails so to speak. The expectation is that if Warsh is chosen, he will be more aggressive than what Yellen would have done. If Powell is chosen, a new contender and current governor, he will likely follow the course she has charted. The chart below shows the current probabilities of the contenders. Warsh and Powell are neck and neck, though the momentum is with Powell.



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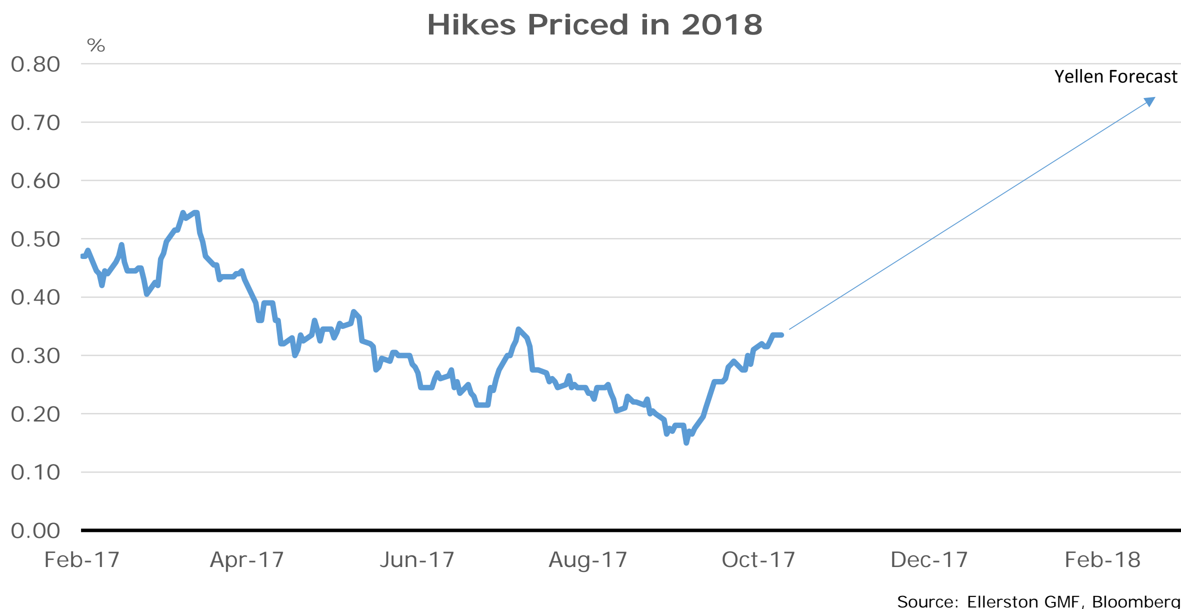
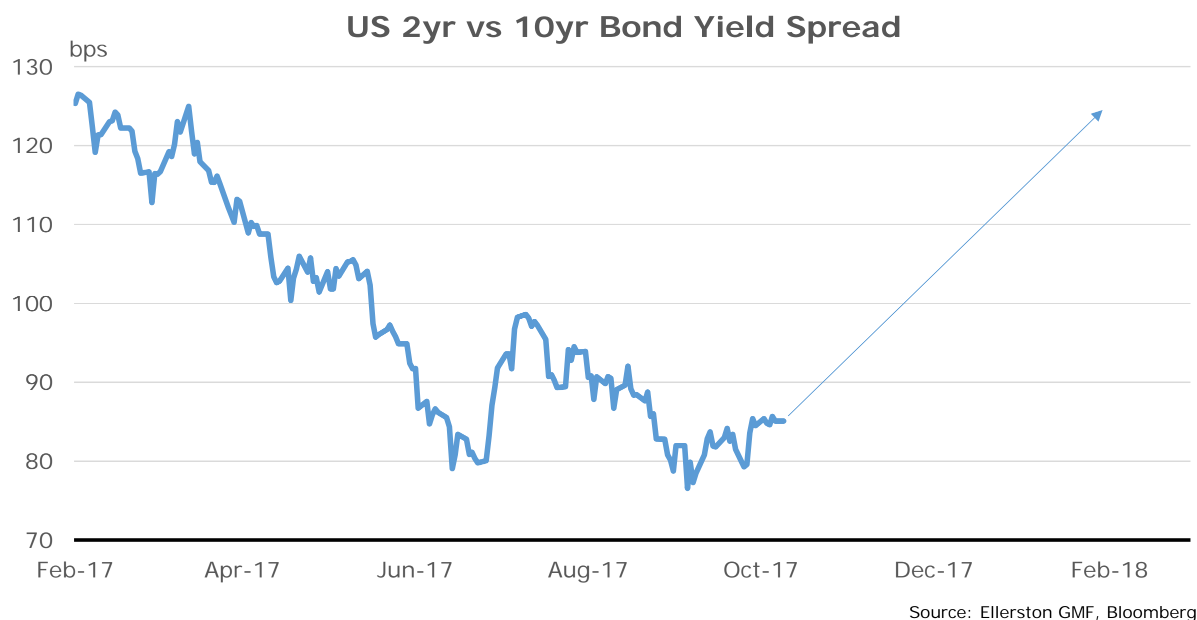
The US market currently expects a 33 basis point rise in rates in 2018, following the December 17 move. Yellen expects 75. We are pretty comfortable with Yellen's view.

[4] https://www.predictit.org/Market/3306/Who-will-be-Senate-confirmed-Fed-Chair-on-February-4%2C-2018



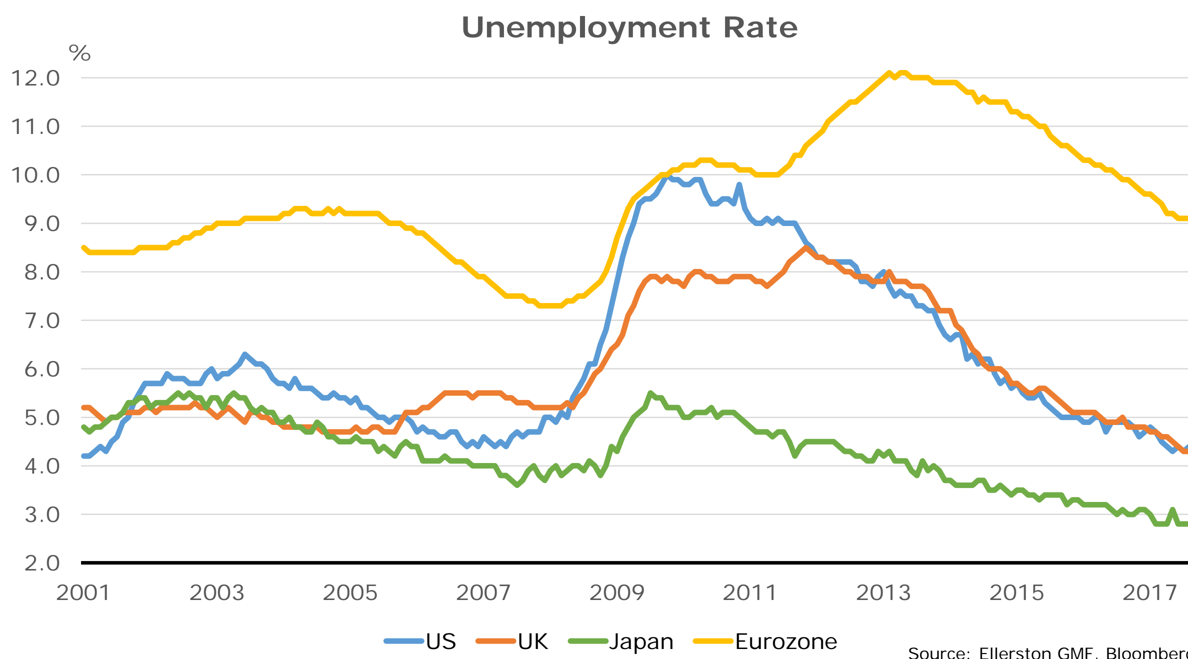
Where we see even more opportunity is for longer dated yields to rise. Why? That was last month's note; "How deep is your love?" We expect higher inflation in the next 6 months, and the unwinding of global central bank balance sheets, to see the real yields, or risk premium on bonds, return to "normal" levels, some 100 to 150 basis points higher.

So we expect US 2 year rates to go higher. But we expect US 10 year rates to go even higher. We can get an excellent risk reward for that view via the options markets.[5]



What is really exciting to us is that the whole world is improving. UK unemployment is the lowest in 42 years. Japan the lowest in 23 years. The US just shy of the lowest level ever, 3.8% in 2000.

[5] We have conditional steepeners in mid-curve Eurodollar contracts. Great for an explosive move in rates.



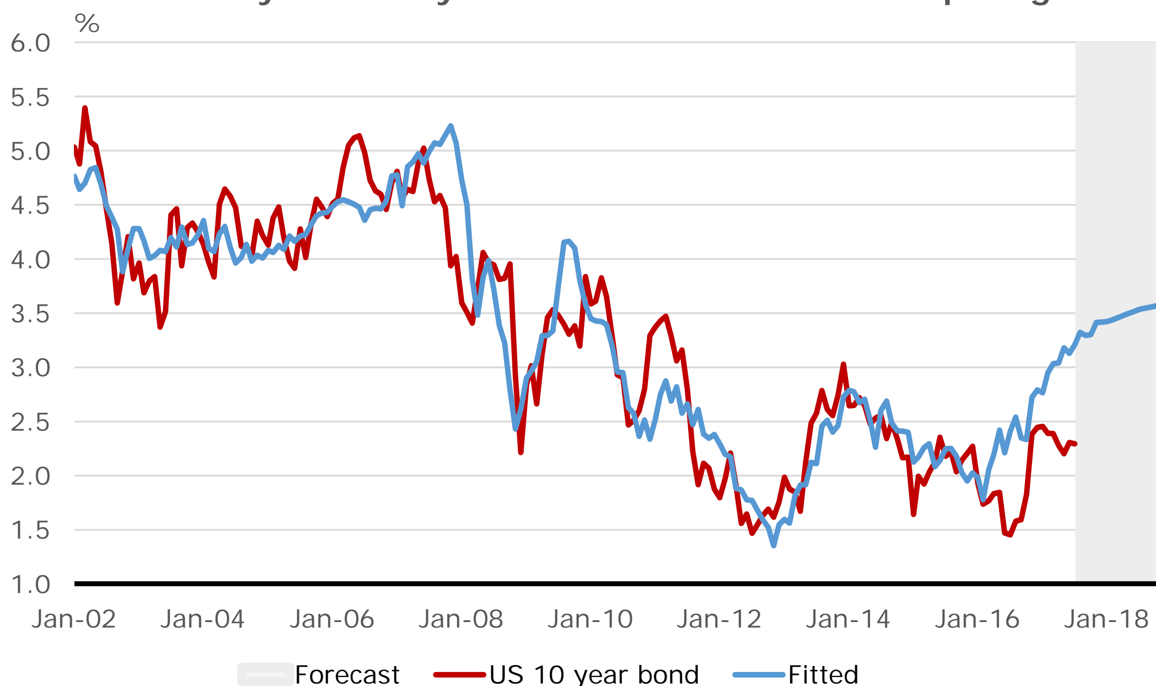
And with it we will get synchronised policy. We will likely have three rate hikes from the Fed this calendar year, three from the Bank of Canada and one from the Bank of England. We expect Australia and NZ to be hiking next year, and Europe and Japan in 2019. A fair bit for markets to digest…

So what should you do? Are things about to change? We think so. We think all investors should be asking two questions;

1. How will my portfolio perform if cash rates rise?
2. How will my portfolio perform if bond yields rise significantly?

It is pretty clear to most now that cash rates will rise globally. Most are debating the magnitude, not the direction. I have explained in the past that equity markets (and credit) can cope with a rising cash rate if bond yields don't rise significantly. If you expect benign movements in bond yields despite rising cash rates, you can continue to hold equities and credit.

However, we think bond yields will rise significantly. We expect a clear pickup in inflation in the US, but even without inflation the unwinding of central bank balance sheets will "normalise" risk premium on bonds.



If that happens, you don't want to be holding bonds or equities or credit.

So you could hold cash.

Or focus on an absolute return fund. But be careful if it is holding credit. And be wary if it needs liquidity, say an ETF. If things get rocky that quickly becomes a problem.

Of course this is an ideal environment for a global macro fund, which is why we are so excited. But there is no guarantee a global macro fund will deliver returns in this environment. It depends on the portfolio manager's view, and how well he positions for it. Nonetheless, it is what macro funds do – forecast economies, central banks, and market reaction, and then position in the best asset long or short to monetise that view. Historically when central banks are moving rates, global macro managers have performed very well, with or without a large movement in bonds.

I hope I have convinced you of at least one thing – consider what happens to your portfolio if bond yields rise.

Perhaps buy some insurance. Or at least a fire pump!

Brett Gillespie

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