

The Great Disagreement – an important update

In August 2014 we wrote a piece titled "The Great Compression" regarding the risks associated with the massive compression in risk premia¹ and the potential effects of the US Federal Reserve ("the Fed") starting to increase US interest rates in 2015. We also informed investors that we had increased the cash weighting of our Global Equity Strategy to approximately 10% as a partial risk mitigation.

Since we wrote to investors in August 2014 the oil price has collapsed, the European Central Bank has commenced a large scale sovereign QE programme, the US dollar has appreciated materially, China's economy has slowed and risk premia across equity and credit markets have continued to compress. Today there is a "Great Disagreement" as to where US monetary policy (and hence US interest rates) is headed over the next three years or so. In one corner is the Fed which is anticipating a normalisation of the US economy and US monetary policy (and hence higher interest rates) over the next three years or so. In the other corner is "the market" which is effectively pricing secular stagnation with prolonged lower inflation and growth (and hence lower interest rates). In our view it is unusual to see such a fundamental and important disagreement between the market and policy setters. In our view, if the Fed is right, many assets are mispriced at the moment and a normalisation of US monetary policy could lead to material losses for investors.

The scale of this disagreement is staggering. At present, the market's forecast of overnight indexswaps are pricing the Fed Funds Rate (FFR) at 1.7% by the end of 2017. This compares to the median forecast for the FFR by each Federal Reserve member at 3-3.25%. The gap between the market's and the Fed's forecast of short term interest rates in 2017 is almost 1.5%. The gap is even wider when you compare longer run forecasts of short term interest rates. Worryingly, we believe that this translates into a large gap between the long term risk free interest rate assumed by equity investors and the implied long term risk free interest rate assumed by the Fed. As an illustration of the implications of this divergence, the difference between the value of 30 year bonds yielding 3.5% and 5.0% is approximately 25%.

If long term rates rise more than the market expects, there could be a similarly adverse impact on equity valuations.

While we do not rule out the possibility of secular stagnation in the US, we believe that many of the near term economic forces (such as the collapse in the oil price) will prove to be transitory and the most likely outcome is that the Fed will need to neutralise monetary policy over the next three years or so. This will result in materially higher US interest rates than the market is currently anticipating. Many investors have cited the current low inflation environment as a reason to doubt the necessity for the Fed to raise interest rates to levels anywhere near pre-crisis levels. However, as the oil price and the US dollar stabilise, and as wages growth returns, inflation is likely to head back towards the Fed's target of 2%. We do not expect a break-out in US inflation; we believe normalising inflationary pressures, diminishing labour market slack and the size of the Fed's balance sheet (over US\$4.5 trillion in assets) will force the Fed to normalise monetary policy over the course of the next three years.

We believe that the economic events of the last eight months or so (the dramatic fall in oil prices, the appreciation of the US dollar, falling Chinese growth, some poor economic data in the US in recent months) have clouded investors' judgment and increased confirmation bias regarding the case for secular stagnation. We would also add that there appears to be anchoring bias associated with such a prolonged period of low interest rates which makes a normalisation of monetary policy in the US almost seem radical and implausible. We regard the current market environment as anything but normal. Yields and spreads across a range of credit markets are at or near historic extremes. We have witnessed a number of high quality corporates issue debt at negative interest rates, and many European sovereigns (including Switzerland, Denmark, Germany, the Netherlands and Belgium) are experiencing negative yields on debt of up to five years to maturity. Investors are now effectively paying European governments or certain corporates to borrow money. Furthermore, spreads between German Bunds and US Treasuries are at their highest levels since

¹ The difference between the expected return on a security or portfolio and the benchmark "riskless" rate of interest is often termed its risk premium. Underlying the terminology is the notion that investors should receive a premium for bearing risk.

before the reunification of Germany. As investors we find this unprecedented and somewhat confronting.

As a consequence of a further compression in risk premia (i.e. asset prices have continued to rise) since August last year we have, over the past two months, increased the cash weighting in our Global Equity Strategy from 10% to 15%. The cash weighting increases the defensiveness of our portfolio and should act as a partial hedge to increasing US interest rates.

The experience of 1994 highlights that risk premia can adjust rapidly, even in a non-recessionary environment. Countries like Australia, and many others, could potentially encounter a 'double whammy' situation where rising US Treasury yields and widening spreads cause a sharp spike in yields. This is exactly what happened to Australian government 10-year bonds in 1994 when yields rose over 350 basis points from February to December. Over this period the price of an Australian government 10-year bond fell by approximately 21%. US corporate high yield (5 to 7-year) credit markets also suffered large valuation losses, with yields spiking 485 basis points over the same period.

It is critical that we ask ourselves the reasons we may be wrong.

The first and most plausible reason is the proponents of the secular stagnation theory turn out to be right. If nominal growth in the US is meaningfully lower than we, and the Fed, anticipate in the medium term, then it may be appropriate for the Fed to run monetary policy targeting materially lower interest rates. If US inflation runs closer to 1% in the longer term, as opposed to 2% as currently anticipated by Fed members, then it may be appropriate to run monetary policy with interest rates closer to the market's current expectations. While we do not believe this is the most likely outcome we cannot totally discount the possibility of secular stagnation in the US over the medium term.

The second, and in our view less plausible, argument for lower US interest rates is the effect of exceptionally low European and Japanese bond yields on the demand for US Treasuries. For as long as European and Japanese bond yields are at exceptionally low levels (maybe due to central bank demand as a result of QE or weak economic fundamentals) then investors will sell bonds in countries like Germany, France and Japan and buy US Treasuries. Therefore, this demand from large foreign buyers for US Treasuries will keep US longer term interest rates low, irrespective of US economic

fundamentals or what monetary policy the Fed attempts to implement. In our view this is a rather simplistic view of how markets and central banks work and is akin to believing in the "tooth fairy". In our view market participants will only sell bonds in Europe or Japan to buy bonds in the US on the basis that they expect to make a profit from the apparent interest rate arbitrage.

So let's examine one way this argument breaks down under a likely set of future circumstances and a possible Fed response. Let's fast forward a few years. Growth in the US has now normalised, US inflation is running at around 2%, US unemployment is below 5%, US wages growth is above the rate of inflation and the Fed's balance sheet remains exceptionally inflated at around US\$4.5 trillion. In light of this economic data the Fed has raised the short term interest rate to 3.75%-4.0%. However, the 10 year US Treasury yield is sitting at around 3.5% because of all of the selling of bonds in Germany, France and Japan and buying of US Treasuries. The Fed would be confronted with an inverted yield curve which many economists would argue is too accommodative for the economic circumstances. In order to avert a disaster in the future the Fed reaches the conclusion that longer dated US Treasuries should be at a higher yield to remove monetary accommodation. Confronted with this economic reality the Fed decides to issue the following statement:

"Over recent years the FOMC has responded to the improving economic situation by increasing the Federal Funds Rate from a target rate of 0-0.25% in 2015 to the current target rate of 3.75%-4.0%. The unemployment rate and inflation expectations are now at or above levels consistent with the Fed's mandate of full employment and price stability. The FOMC is concerned that market yields on longer dated Treasuries remain exceptionally low and could fuel expansion inconsistent with the Fed's mandate. The Fed considers a more neutral policy setting would be to have the 10 year Treasury yield closer to longer term averages, which would imply a positively sloped yield curve. If market prices do not adjust within a reasonable period the FOMC will revisit the composition of its holding of US Treasuries and may consider a reverse twist operation² or outright sales from its portfolio."

In light of such a statement it is unlikely market participants would continue to buy US Treasuries at exceptionally low rates given the Fed would have almost guaranteed investors that they would lose money, since they would be confronted by the possibility of sustained and heavy selling of US Treasuries by the Fed. We

² A reverse twist operation would sell long-dated US Treasuries and buy short-dated US Treasuries, causing a steepening of the yield curve.


therefore believe the US economy will be the driver of future interest rates and not external factors like arbitrage driven demand.

The key question is not *when* the Fed commences raising interest rates, but by *how much* they will increase rates in the next few years and what will normalisation look like. Where US monetary policy is heading is an economic question and not a question of apparent market demand for US Treasuries. We have confidence that the US Fed will react appropriately to the economic circumstances prevailing in the future and set monetary policy accordingly.

It would appear that many investors are presently very confident in their ability to "get off the merry-go-round" before the music stops. Most investors clearly understand that the Fed will commence increasing US interest rates shortly however it would appear that many investors aware of the potential risks of rising US interest rates feel confident in their ability to ride this wave right to the shore. As I stated in the update last August investing is a long-term endeavour and we believe it is appropriate to risk giving up some short-term return in order to protect our clients' capital. As Warren Buffett has often reminded investors "To finish first you must first finish". It may turn out that we are right to be cautious but that we are too early in reducing our equity risk in the portfolio. Indeed it could be argued that we moved too early in reducing risk in August last year. We have no interest in being "Cinderella" at this ball, staying too late and thus risk everything turning to pumpkin and mice.

Of course, there is a possibility that the US may be in secular stagnation and long-term bond yields do not rise to the levels we anticipate, and markets remain benign or even strong. In such a scenario, the decision to increase our cash weighting will be a drag on short-term performance. However, the cost of taking out this additional insurance is likely to be small, and the Global Equity Strategy will remain 85% invested in high quality global equities. Indeed under such a scenario this remaining 85% of invested capital may well deliver even better returns to our investors than our current expectations. Even if we are wrong in our judgment that US monetary policy will normalise over the next three years it does not lead to the conclusion that it is wrong to take out some insurance for "the Great Disagreement". No one could be 100% certain about the case for secular stagnation and these extraordinarily low rates prevailing. We believe it is better to be prudent, given the current set of facts, than be complacent.

At this point in the cycle we have judged it is right to further increase the cash weighting in our Global Equity Strategy to provide some additional protection for investors as the US economy and monetary policy normalises over the next few years.



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