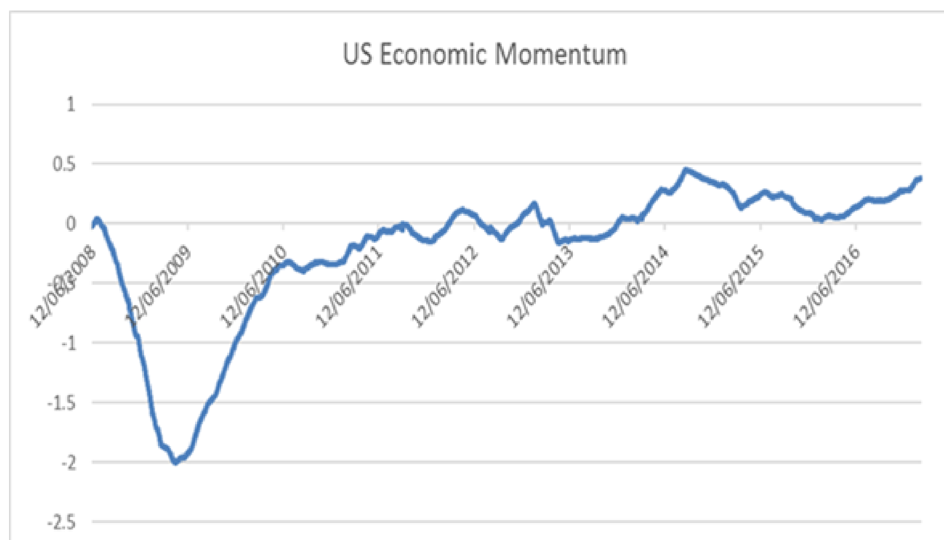
Realm Investment House Update – Rates & Risk **21 February 2017**

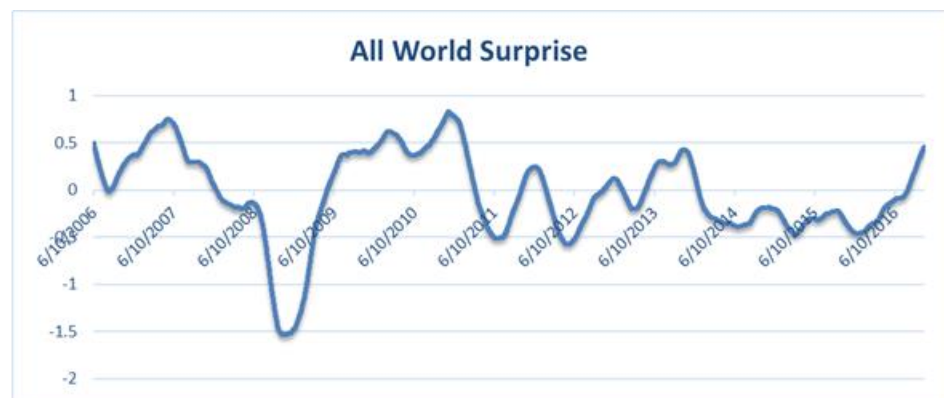
As many you may have observed the portfolio now maintains quite a defensive posture, with approximately 40% of fund assets invested within cash, short term liquidity and Australian Commonwealth and State Government Debt.

Just a couple of observations that are colouring portfolio composition at present.

On Global & Long Term Rates - Our top down monitors are clearly illustrating strengthening economic momentum in North America, Europe and China. In the United states a number of inflation and cost side measures are also showing signs of life for the first time in a long time.



The chart below tracks the momentum of the world's economic surprise indices, e.g. the difference between data and expectations, what is of note is that these beats are occurring on rising expectations. This generally drives a cycle of upgrades as forecasters seek to play catch up, this can often create its own market momentum.



In addition, a renewed focus on fiscal expenditure seems to be getting anticipated by markets. Chinese iron ore stockpiling and steel production seems to be attempting to front run a global boom in infrastructure investment. What is more this is mooted to occur at a time where data is generally reasonably healthy.

Those who encourage investment now take the view that these old axioms simply don't hold given an assumed lower level of long term rates. This is an interesting view that is at odds with crowding out theory.

In July/August of last year the market was pricing in a deflationary outlook. The US 10-year bond yield has risen by more than 1% since then. However, on our numbers US 10 year bonds are still trading moderately expensive. There is certainly a real risk of another leg higher in global long bond yields over the shorter to medium term in the absence of an unforeseen political or market calamity.

On Australian interest rates – Domestic economic momentum has strengthened somewhat off a lower base over the last quarter as commodities, PPI's and private sector credit growth have offset continued weakness in wages, retail sales and private investment. This has also continued to underpin the Aussie dollar. The recovery in the bulk commodity complex seems to be driven by more than simple speculation which may indeed provide a source of frustration for the parts of the market that desperately need the assistance of a weaker Australian dollar.

At the same time, Australian household risk has started to rise again. This is being driven by a renewed momentum in house prices, strong growth in unsecured debt and weaker income growth. The last time system risk got to these levels APRA were effective in quelling the risk by attacking interest only risk (by focussing on borrower's assessable income) and softening investor lending (by placing informal limits on investor loan composition). This had the desired impact by softening momentum. The level of absolute risk is back at a level which requires some form of action once again. To that end it was no surprise to see Wayne Byres (APRA's head) back on the front foot recently speaking of the need to push ahead with necessary reforms. APRA's intervention has of course become so much more important of recent times given that the RBA is effectively sidelined given the impact higher rates would have on the Aussie dollar and the economy more broadly. However, what can they do next? In other jurisdictions, we have seen rationing or capping of higher LVR lending, in addition it is clear that APRA are working to close the holes that have allowed non-bank lenders to fund the bank run off of investor risk. Given the rise of intermediation (mortgage brokers) increasing focus or accountability on this sector could also be an area of focus.

What all of this tells us is that it may be tough to justify a rate cut from here, at the same time the importance of low interest rates on household balance sheets is absolutely enormous right now, which equally speaks to the inability to use rates meaningfully to water down the heat in the market. In many ways the current environment almost seems to ensure that rates remain stuck in the nearer term, if anything a continued deterioration in household risk and assuming APRA are unsuccessful in cooling system risk down could perhaps tempt the RBA into a rate rise into year end. However as things stand there is little to justify a strong view either way.

Summary on Rate positioning – The portfolio is being managed around a core position of 0.6 of a year long. Given our prevailing view we would need to see further weakness from current levels to increase our allocation to fixed rate bonds, with the allocation being sourced from our considerable cash overweight. At the same time the strength in risk markets has seen us sell down a good deal of our risk exposure and increase portfolio credit quality which is consistent with our stated approach.

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