Kapstream
—JANUS HENDERSON—

March 2021

February Markets Update

What just happened in fixed income markets?

Last week provided some unexpected excitement in bond markets, with a rapid and surprise spike in government bond yields. On Thursday the US 10yr posted its largest single daily rise in years, lifting it briefly above 1.6% before it settled back, and with Fridays retracement the yield was back down at 1.4%. Locally, the RBA intervened to stem rates volatility, buying $7bn in what was the largest weekly QE purchase volume to date. Notably that included $3bn of Yield Curve Control ('YCC') purchases which is outside its normal program.

What caused it?

Confidence in COVID-19 vaccination programs boosting post-pandemic economic recovery and an ensuing caution over heightened inflation have driven these sharp moves in the short term, however our view remains unchanged that these are rather more knee-jerk reactions as opposed to being evident of a greater systemic shift in sentiment.

What effect have these (rates) moves had on credit markets?

Australian credit softened towards the back half of last week driven to a large extent by Japanese accounts selling as their AUD currency targets were hit. Additionally, the large swings in the rates market caused rate sensitive equities to sell-off, which led to profit taking in credit off the back of a large rally year to date. However, the same was not true of US credit markets with little apparent impact on trade activity nor pricing. Consistent maybe with a more optimistic outlook, many were sitting on cash waiting for yields to become more attractive. Similarly our own headline portfolio positioning (see below) puts us largely in this camp to deploy excess cash into higher yields as opportunities present.

What next?

In our view, the Fed remains the main/only game in town and they (and other central banks) are going to continue to remain very accommodative. We feel that the strength in confidence in a material economic rebound is overblown. Yes, we are seeing more and more people getting vaccinated which in the US notably will serve to allow the reopening of more businesses and a pick up in economic activity, however, eradication of the effects of the pandemic will be more gradual over 2021, not immediate. We expect to see some of the pent up demand of people emerging from lockdown cause a temporary spike in inflation, but do not believe persistently high inflation to be a 2021 story. US jobs are still far behind pre-pandemic levels and high and sustained job gains will be necessary to drive wage inflation as a precursor to general inflation. We expect to see the US 10yr treasury bond yield moving into a range close to 1.5%. In Australia, we shall follow the RBA's statement but with expectation that it remains neutral-to-dovish, given 1) their extension of QE, 2) additional YCC measures, 3) acknowledgement that meeting inflation targets remains some time away, and 4) relative strength of the AUD.

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How will this impact short term performance?

For any fixed income fund carrying a long interest rate duration exposure of any magnitude, a short and sharp surprise rise in rates will negatively impact performance. Funds with more conventional benchmark-relative duration exposures will hurt the most and will likely deliver fairly sizeable negative absolute returns for the month of February. The standard ‘AusBond Composite’ indices that a large number of more conventional funds utilise as a benchmark returned close to -4% for the period, easily wiping out the already low (coupon) income return available (a structural risk that we have consistently flagged). This is where strategies such as ours that do not seek to track any traditional index, instead having an absolute return (and risk) mindset, and a distinct bias to capital preservation, prove their worth. While not being fully immune, being able to ‘hedge out’ interest rate sensitivity enables us to avoid most of the impact of sharp sell offs, with early indications pointing towards only a marginally negative return for our flagship strategy in February of approximately -0.2%.

What about portfolio positioning?

We had been reducing our already relatively modest duration exposure but given our longer term view that rates remain on hold for the medium-long term still maintain interest rate exposure in the 1.2yr – 1.3yr range in flagship portfolios, and within that we are focused on the shorter-dated end of yield curves where volatility has been far less. Equally, the underlying bonds we own are biased towards shorter-dates issues (~80% of the portfolio is held in <5yr maturity bonds). We have also materially higher exposure to ultra-liquid assets (such as cash and sovereign bonds), having lifted this element by 2% to ~10%. We also bought some CDS protection (we view this as low-cost insurance should rates continue to increase causing further softness in credit markets, given the tightness of credit spreads). However, we are not concerned about a return to March-April 2020 levels of volatility given a backdrop of improving company fundamentals and QE, rather we are waiting in hopeful anticipation of a small amount of further credit spread widening to provide a ‘buy-the-dip’ opportunity, whilst we also continue to take advantage of a promising pipeline of new issues, providing strong relative value switch opportunities.

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