

2020 Outlook: Australian Fixed Interest

December 2019 | Jay Sivapalan (CFA), Janus Henderson Investors

What are the key themes likely to shape markets in 2020?

After a year of highly coordinated monetary policy by central banks globally, and the finalisation of 'phase 1' of the US/China trade agreements, we're envisaging very little change in monetary policies over 2020.

Against this backdrop, the current market expectations of cash rates easing further in a number of countries are likely to be paired back. Should this occur, we'd expect global bond yields to be a little higher.

The prospects of materially lower bond yields in 2020 have diminished in our assessment. This represents a significant shift in the future return expectations of the asset class, coming off double digit returns in 2019 to something that will likely represent the (lower) income yield of the asset class. Without the tailwind of falling bond yields (as was the case in 2019) and with little income to protect against smaller spikes in bond yields, the broader market will likely have more incidences of negative monthly returns offset by positive ones. In short, lower returns combined with greater volatility.

The Australian bond market is likely to follow global markets, but we expect it to outperform markets like the US, which have stronger economies at this point in the cycle. In terms of economic growth, Australia is still very much in the 'muddle through' scenario, with significant assistance from public spending while housing construction readjusts amid mild consumption levels. The Reserve Bank of Australia (RBA) is expected to ease monetary policy further in 2020 to 0.50%, which will help keep longer term bond yields anchored from rising too much compared to the US, for example.

Where do you see the most important opportunities and risks within your asset class?

In rates markets, the biggest current opportunity we see going into 2020 is the mis-pricing of expected inflation over the next decade or two. In Australia's case, nearer term inflation has settled around 1.5% and is expected to stay relatively low for some time to come. However, markets have discounted any positive impact on future inflation from both monetary policy and upcoming fiscal policy by way of tax cuts over the next three to five years.

To illustrate, the current expected inflation over the next decade is around 1.35%, a result that has not been experienced over rolling 10 year periods over the past 70 years for which data is available. In our view, inflation linked bonds are currently attractively priced and provide investors with cheap inflation protection.

In credit markets, we see both opportunities and threats. In an ongoing low yield world, the value of additional yield from corporate debt is very useful for investors. Fundamentals for higher investment grade quality companies remain strong, with prudent management and modest gearing levels. Exposure to these

companies can deliver total returns that are comfortably double or triple cash rates and risk-free asset yields.

The other area we re-entered in early 2019 and continue to see as providing attractive risk-adjusted returns for investors is prime AAA Australian Residential Mortgage Backed Securities (RMBS). Having been largely inactive in this sector from 2015 to 2018 based on concerns related to lending standards, an imprudent mix of interest-only loans and elevated investor segment exposures, we found the fundamentals for the sector turned in 2019, coupled with a more positive macroeconomic backdrop.

On the flipside, we see significant yield-chasing activity by investors into lower quality credit and illiquid assets. Some of this is being done with a good appreciation of risks involved and some less so. Similar behaviour was witnessed during the past few cycles, but in particular during the 2004-2006 period.

The biggest risk we see is not necessarily the mark-to-market volatility of lower quality credit, but the prospects for permanent loss of capital and illiquid underlying assets in a less favourable part of the cycle. This can have the effect of destabilising credit markets overall and having some impact on even higher quality credit.

How have your experiences in 2019 shifted your approach or outlook for 2020?

One of the key lessons from 2019 has been the impact of geopolitical events. The trade wars and Brexit, for example, haven't only affected financial market volatility, but also impacted business confidence and investment, which has ultimately circled back to impact economic growth.

18 months ago, most investors wouldn't have expected the US Federal Reserve (Fed) to cut rates in an economy that was finally growing after a decade of post-GFC repair. With the US finally being joined by a number of other economies in a period of synchronised global growth, this represented the first opportunity to move away ever so slowly from ultra-easy monetary policy.

Looking to 2020, while hard to predict, geopolitical events continue to feature as key threats to investors' base case scenarios. As such, greater emphasis should be placed on keeping abreast of these non-fundamental developments that can ultimately impact economies.

What do you think will be a key indicator to watch?

For Australia, labour market developments will be important in assessing whether recent softer business confidence and consumption data is of a temporary or more permanent nature, requiring additional monetary or fiscal policy responses.

This has implications for bond yields, and by extension, expected returns for investors in the Australian Fixed Interest asset class. For investors, unemployment and underemployment will be vital to watch, including some early indicators such as job vacancies and advertisement data.

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