Actuaries Institute

Fearing Higher Bond Yields: The Only Thing We have to Fear is Fear Itself?

Stephen Miller, Managing Director, Head of Australian Fixed Income

July 2013

Agenda

1. The backdrop. Did policy work?

2. Forks in the road.
   - US
   - Europe
   - Japan

3. What does it mean for financial markets? Are we in a regime change?

4. The rest of 2013: Scenarios

1. The backdrop. Did policy work?

What caused the sharp increase in yields from mid-May?

"The only thing we have to fear is fear itself"
FDR, Presidential Inaugural Address, Mar 4 1933

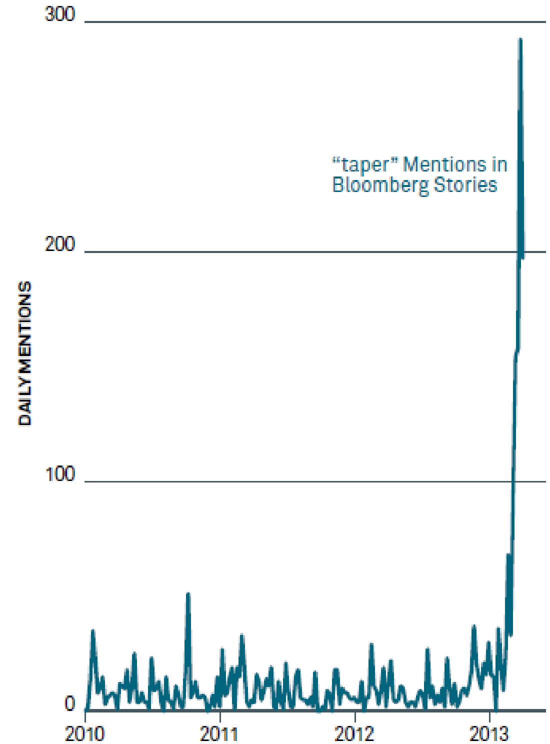
"We would in the next few meetings take a step down in our pace of purchases"
Fed Chairman Bernanke, May 22 2013

"A highly accommodative monetary policy will remain appropriate for the foreseeable future"
Fed Chairman Bernanke, July 17 2013

"..if the outlook for employment were to become relatively less favourable, if inflation did not appear to be moving back toward 2 per cent…the current pace of purchases could be maintained for longer."
Fed Chairman Bernanke, July 17 2013

Tapering is conditional!

TALES OF TAPERING
Daily "Taper" Mentions, 2010–2013



Sources: Thomson Reuters and Bloomberg, June 2013.
Note: US yield breakdown uses inflation-linked US bonds to calculate a breakeven inflation rate.

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Scenarios: What now for asset markets?

1. Stop 'N Go

- On-and-off growth spurts in the United States and emerging world. Europe veers in and out of recession and Japan proves another false dawn. Bank delevering dampens growth and risk taking.

2. Nemesis Redux

-The prospect of a global recession, deflation or credit crunch (or all of the above) triggers steep losses across asset classes. Named after the Greek goddess who punishes the proud.

3. Go Growth

-Key economies grow faster than expected. The global economy and markets start weaning themselves off ultra-loose monetary policy around the developed world.

4. Age of Separatism

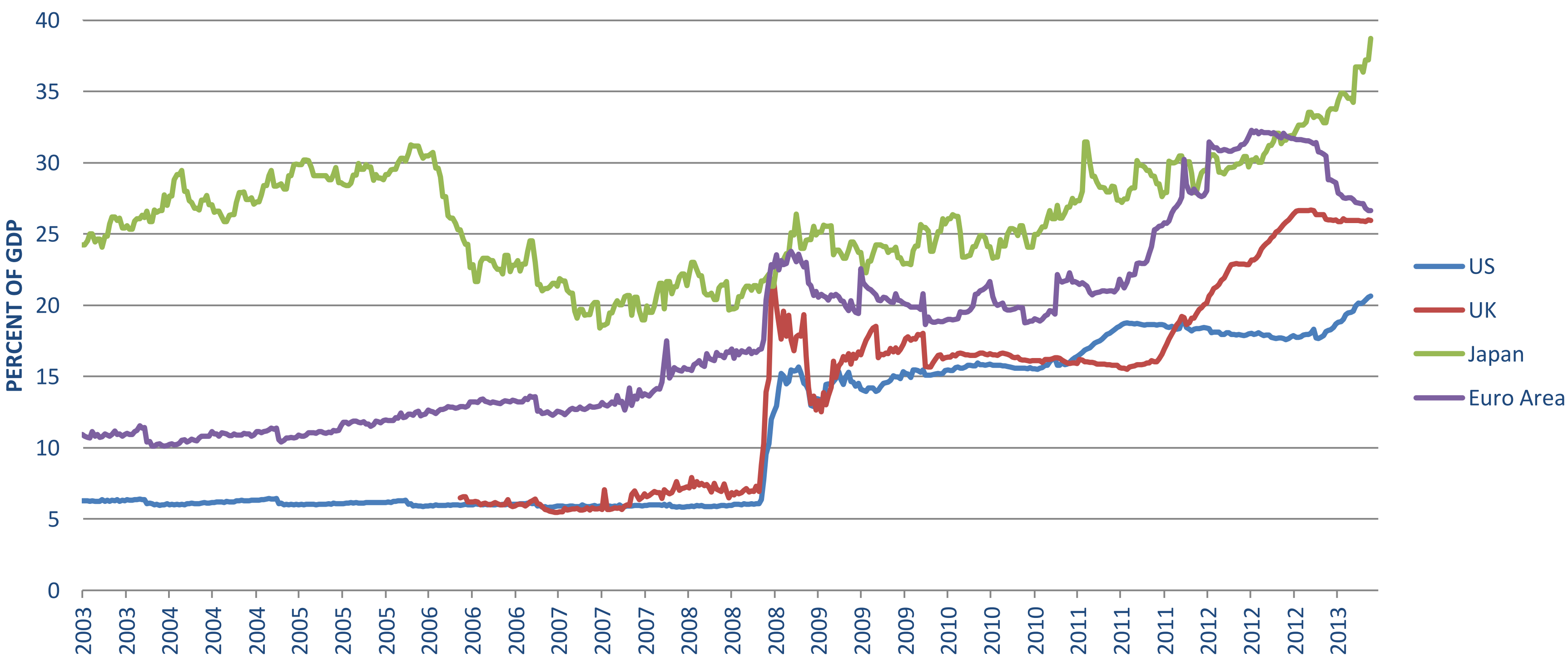
-Increasing divergence between economic growth, policy moves and financial market returns (between and within asset classes, countries, industry sectors and individual securities).

5. Inflate Away

-Monetary easing triggers inflation, effectively cutting the developed world's debt load. Alternatively, a Middle East conflict and/or disastrous harvest season drive up energy and commodities prices.

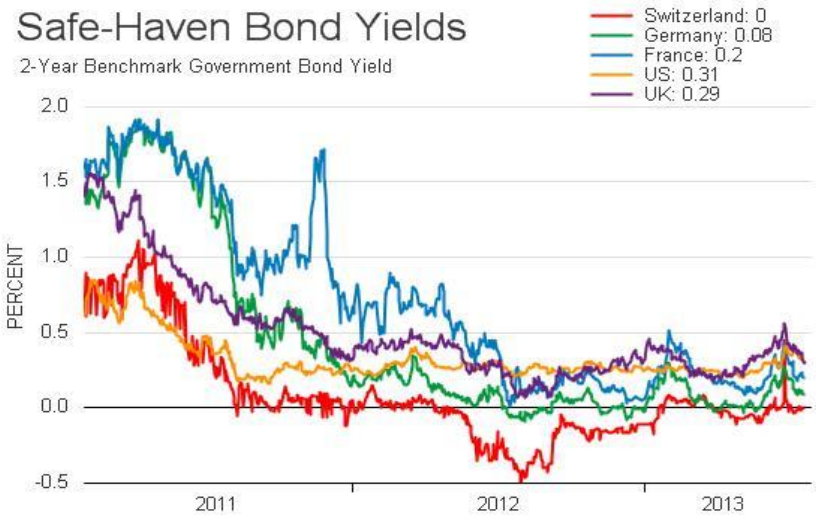
Policy dominates financial markets and markets were feeling bloated

Central Bank Balance Sheets as Share of GDP, 2003-2013



- Central Banks have bought assets on a scale never seen before.
- Central Banks have expended too much capital – monetary, intellectual and reputational – to reverse the stimulative policies prematurely. However, monetary policy is going to start to diverge in the key "core" developed markets.
- The Fed will start "tapering"; the ECB will keep key credit channels open; the BOJ is "all in" with a $US1 trillion stimulus bet

Policy worked! Asset class returns



Source: Thomson Reuters Datastream, BlackRock Investment Institute 18/07/2013

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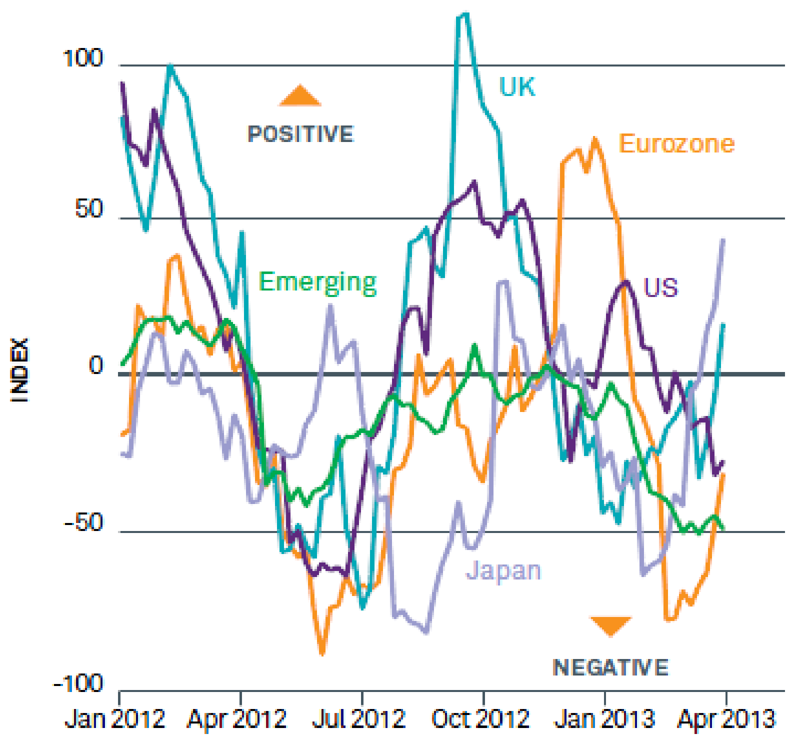
Source: Thomson Reuters Datastream, BlackRock Investment Institute 18/07/2013

Are developed economies about to grow?

- The growth backdrop is the key for defining future policy.
- The US economy is expected to lead the world economy with 2.25% for the next 12 months, according to consensus estimates, followed by Japan and the UK. The Eurozone is stuck near recession levels. Forecasts for growth in key emerging markets have steadily dropped.
- But GDP growth often doesn't move markets – but expectations of it do.
- Most economic data from developed economies have started to surprise to upside.
- Emerging markets have gone the other way.

BEATING (LOW) EXPECTATIONS

Economic Surprises, 2012–2013



Sources: Thomson Reuters and Citigroup, June 14, 2013.
Note: A positive reading of the Economic Surprise Index suggests economic releases have been beating consensus forecasts.

2. Forks in the road

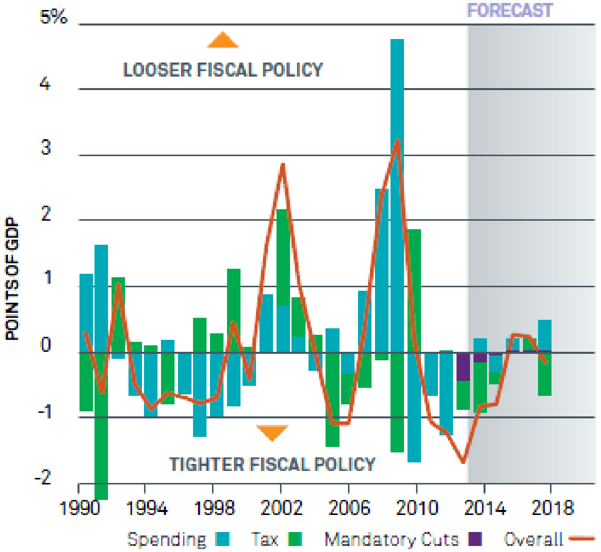
Forks in the road

ASSET		POLICY PRICED IN	ALTERNATIVE POLICY PATH	PATH'S IMPACT
DEVELOPED STOCKS	Eurozone	ECB muddles through; cuts discount rate.	Eurozone resolution through banking union, some debt mutualisation.	Big upside
			ECB's programme of Outright Monetary Transactions (OMT) is tested – and fails.	Big downside
	United States	Fed starts reducing bond purchases by year end.	Fed "tapering" is sooner or bigger.	Downside
	Japan	BoJ is "all-in" on QE; government provides some fiscal stimulus.	Less fiscal stimulus than expected.	Downside
			More fiscal stimulus; labour reforms and deregulation.	Big upside
EM STOCKS	Emerging Markets	Imminent Fed tapering; no China stimulus.	Fed tapering is slower and smaller; China launches stimulus.	Big upside
			Fed tapering triggers full-blown funding crisis.	Big downside
SELECT BONDS	Eurozone Peripherals	ECB muddles through.	Eurozone resolution.	Big upside
	US Short-Term Rates	Fed tapering and rate rises.	Fed tapering is slower and smaller; rate rises are further away.	Upside
	Emerging Market Debt	Imminent Fed tapering; no China stimulus.	Tapering slower and smaller.	Upside
			China launches stimulus.	Upside
COMMODITIES AND CURRENCIES	Industrial Metals	China slows; no stimulus.	China launches stimulus.	Upside
	Euro	ECB muddles through.	ECB goes all-in.	Bon voyage, euro
			OMT fails.	Farewell, euro!
	US Dollar	Fed tapers this year.	Policy uncertainty intensifies.	Upside
	UK Sterling	UK needs more stimulus.	More stimulus unnecessary.	Upside

US: There are some positives for growth

DRAG-FREE

US Fiscal Policy Impact on GDP, 1990–2018

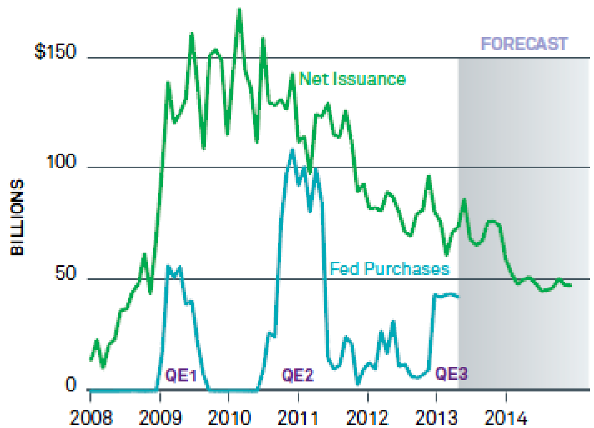


Source: Absolute Strategy Research, June 2013.
Notes: The chart shows the impact of US fiscal policy on real GDP growth. Spending excludes mandatory budget cuts or sequester. 2013 and beyond are based on IMF forecasts.

2. The Fed has to start tapering anyway because it's running out of things to buy…will this limit any rise in bond yields?

EMPTY SHELVES

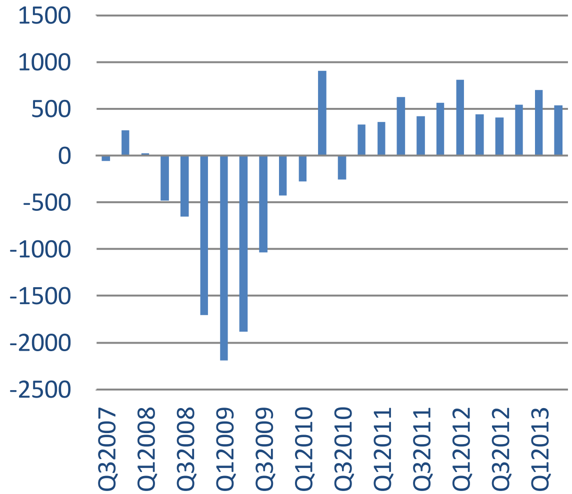
Net US Treasury Issuance and Fed Purchases, 2008–2014



Source: Credit Suisse, June 2013.
Notes: Net US Treasury issuance is a three-month moving average. Dotted line represents Credit Suisse's forecast based on US public deficit projections.

3. New technologies will drive energy prices lower in the US.

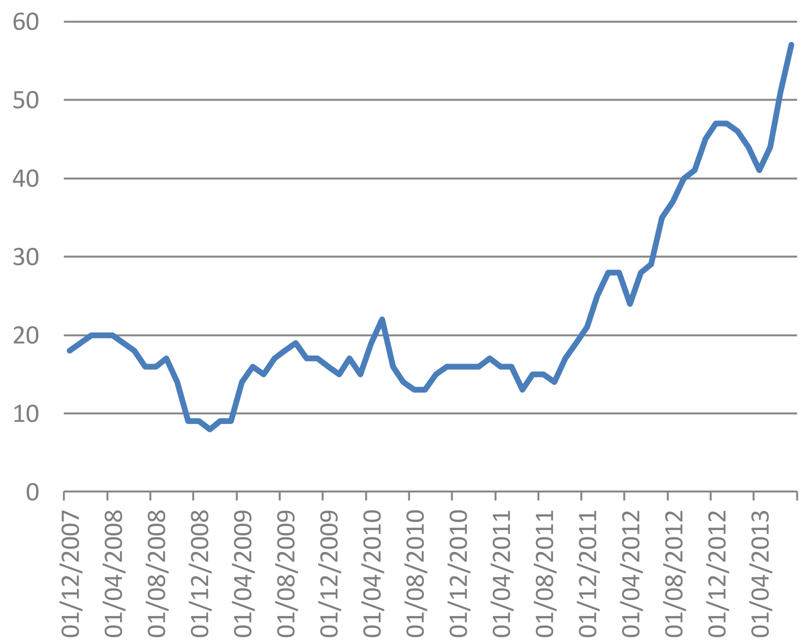
4. Monthly change in US non-farm payrolls



Source: Bloomberg, July 2013.

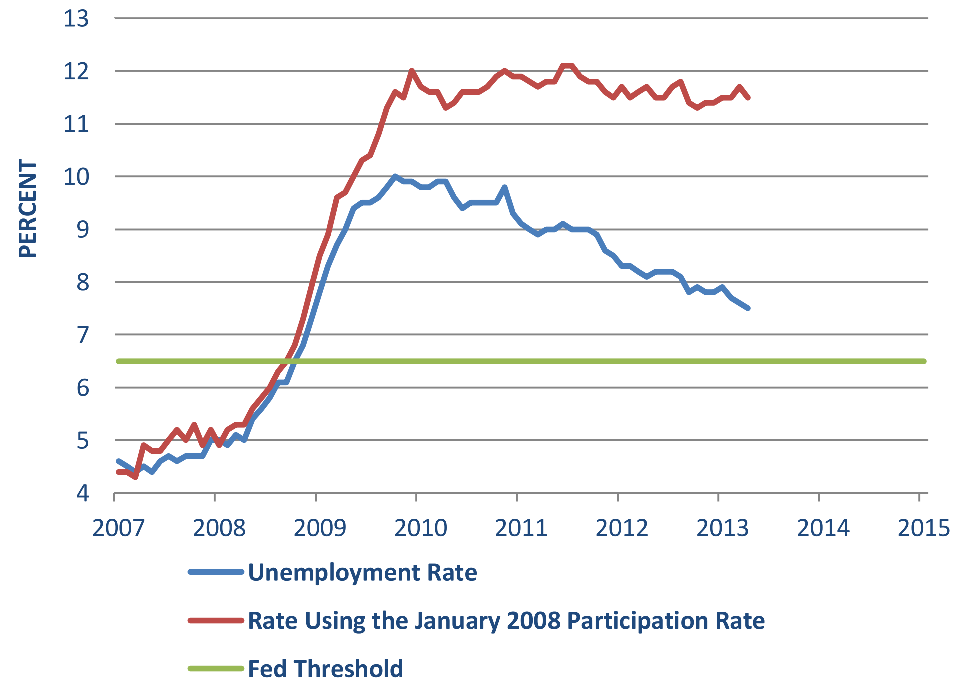
US: taper time – but only if growth continues to strengthen

- Unemployment rate has fallen to 7.5% - but is it as good as it looks?
- US housing market has recovered but again it may be better than it looks.



Source: Bloomberg, July 2013.

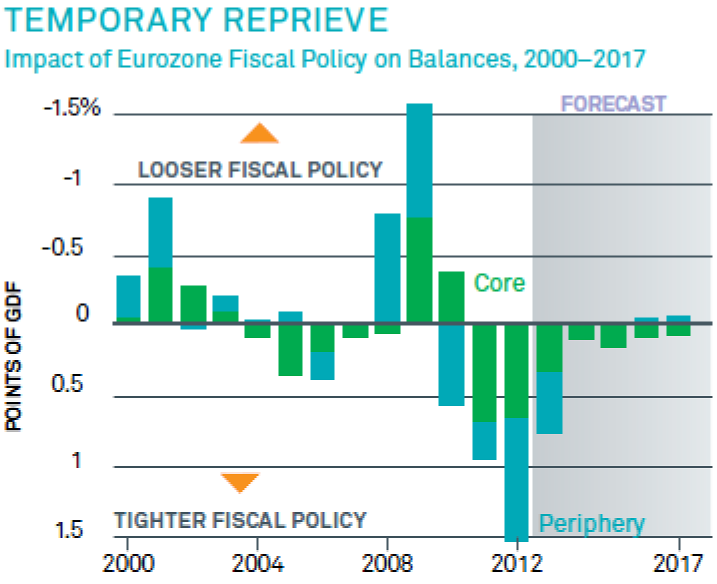
US Unemployment Rate, 2007-2013



Sources: BlackRock and Thomson Reuters, June 2013.
Notes: The blue line represents what the jobless rate would have been if the labour force participation rate had held steady at the January 2008 level of 66.2%, versus an actual rate of 63.3% in April 2013.

Europe: an eerie calm

- German elections constrain the path to further European integration.
- ECB making limited progress on fiscal and banking union.
- Further downgrades in the periphery?
- But….. a fiscal reprieve?



Source: Absolute Strategy Research, June 2013.
Notes: Chart shows fiscal policy impact on structural fiscal balances. 2013 and beyond are based on IMF forecasts.

Japan: The three arrows

1. Monetary Stimulus - The BoJ has vowed to do whatever it takes to get Japan headed toward a 2% inflation target. This means massive purchases of Japanese government bonds (JG Bs) – and potentially private sector assets (watch this space).

2. Fiscal Stimulus – Prime Minister Abe announced a 10.3 trillion yen spending programme in January. Fiscal stimulus alone cannot save Japan, maybe can act as life support while the patient is still in the operating room.

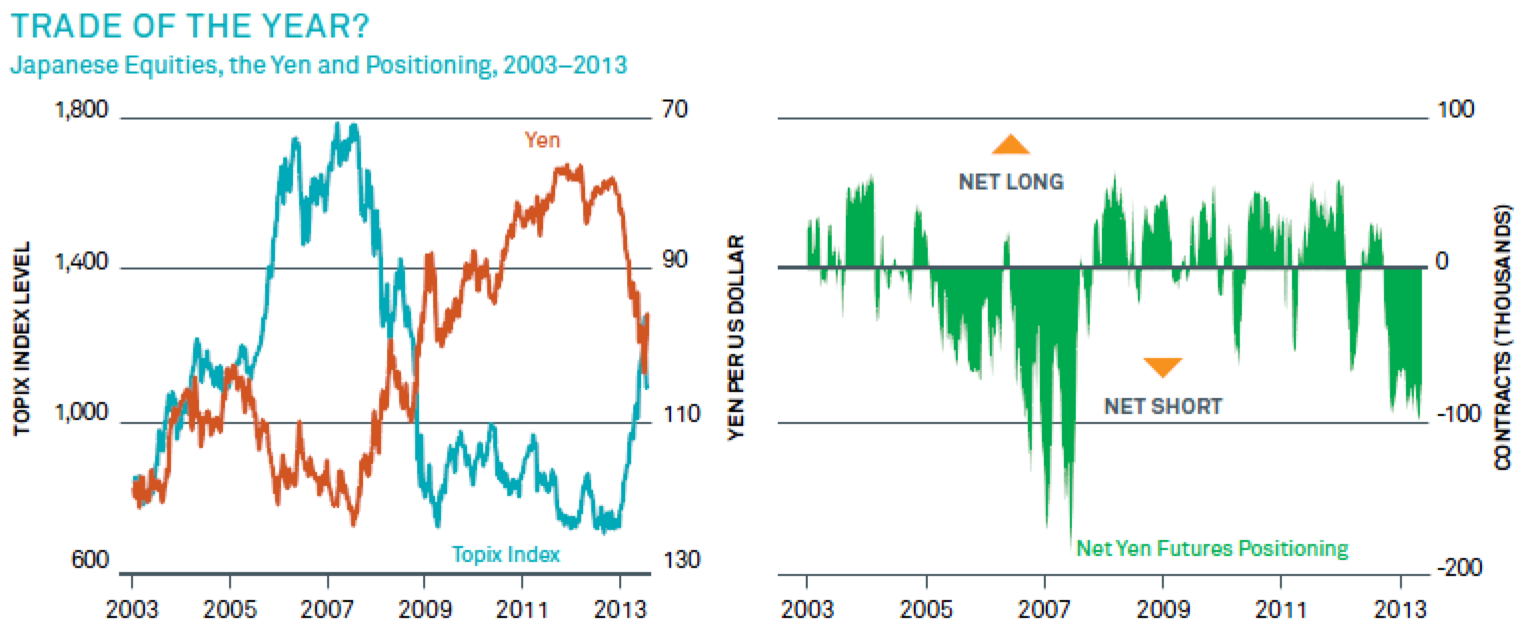
3. Structural Reforms - Domestic sectors such as retail, distribution and agriculture have been shielded from competition. Deregulation is essential. Japan currently under-uses a large, highly educated group of people: women. More working women would boost output and productivity. Pension reform is also key. Japan has a fast-ageing population. The country may have to fix its budget by stealing money from pensioners (cutting benefits).

The third arrow is the most problematic

Japan: The three arrows – it appeared to work….initially.

- So far, foreign investors have been the most enthused by the BoJ's actions. They have helped spark a huge rally in Japanese equities and a selloff in the yen. See the left chart below. Investors got their presents all at once!

- June's partial reversal was a response to extreme positioning – speculators had huge short positions on the yen at midyear, as the right chart shows. In the space of just six months, buying Japanese stocks and shorting the yen went from being the most unloved to the most crowded trade.

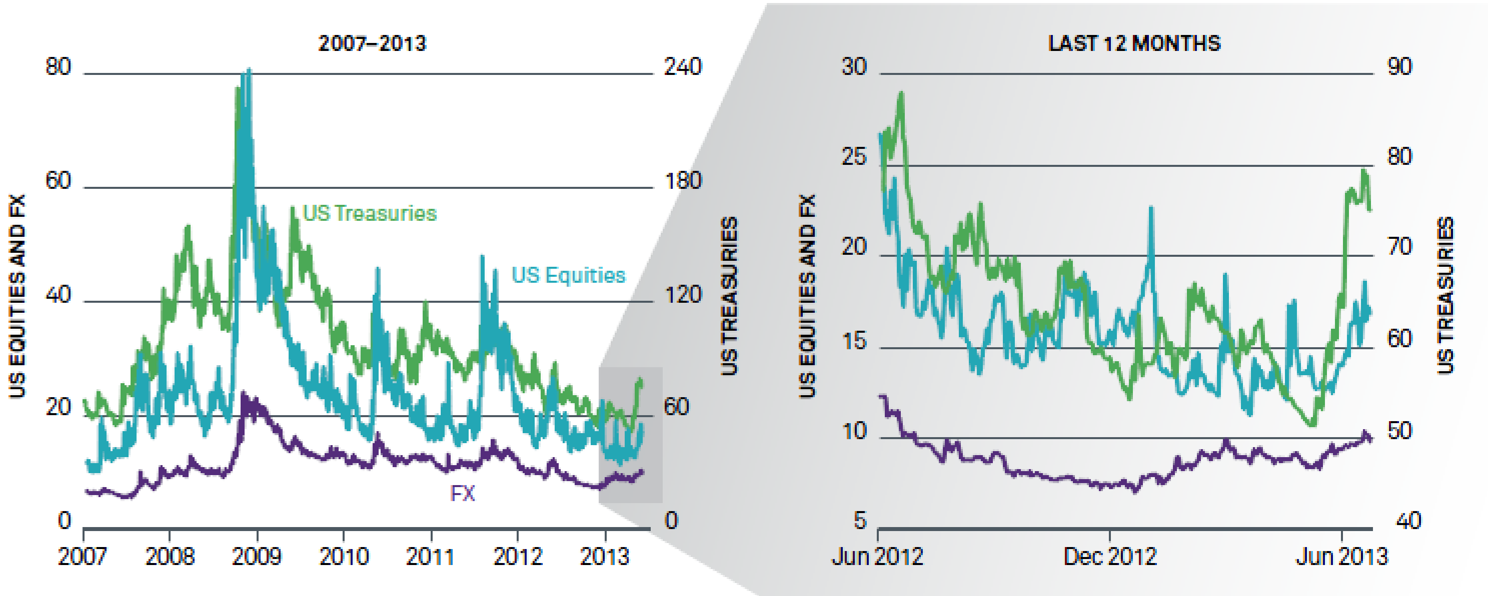


Sources: Thomson Reuters and CFTC, June 12, 2013.
Notes: Yen futures positioning reflects the net position of non-commercial contracts.

3. What does it mean for financial markets? Are we in a regime change?

What does it mean?

Fasten your seatbelt

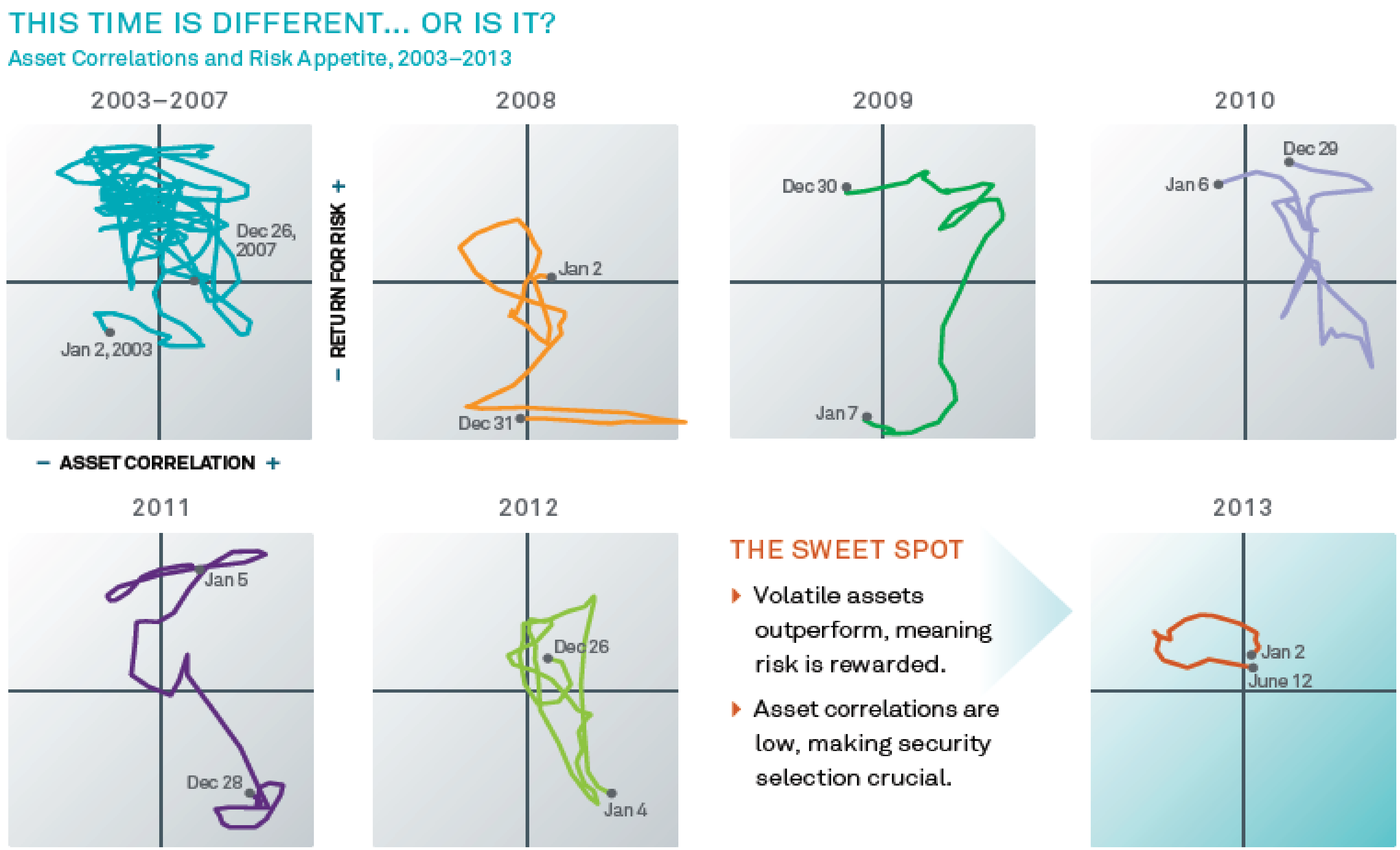


Sources: Thomson Reuters and Bloomberg, June 17, 2013.
Notes: The volatility indices are Merrill Lynch's MOVE index (US Treasuries), Deutsche Bank's currency volatility index and the Chicago Board Options Exchange's VIX Index.

- Market volatility is likely to rise. Investors got a taste of this in June, and we believe there is more to come. Blame dealer retrenchment from markets and (investor fears of) the end of easy money.
- Volatility is still near historic lows, as the chart above shows. This means opportunities for volatility strategies, including option plays to capture upside, protect against downside or generate income.

Regime change?

This time it is different ….. or is it?



Source: BlackRock, June 2013.
Notes: Based on correlations between 14 asset classes. Risk sentiment measures performance of more volatile assets. Time series are smoothed 20-day averages.

When bonds lose money – where does this leave us?

- Valuations are resetting to levels where expectations (about safety and the length of the easy-money era) are better aligned with realities (risk premia used to be wider for a reason and central bankers will take away the punch bowl at some point).
- Safe haven government bonds are still the exception.
- Government bonds hover between 96th and 98th percentile of their historical nominal valuations.

WHEN BONDS LOSE MONEY

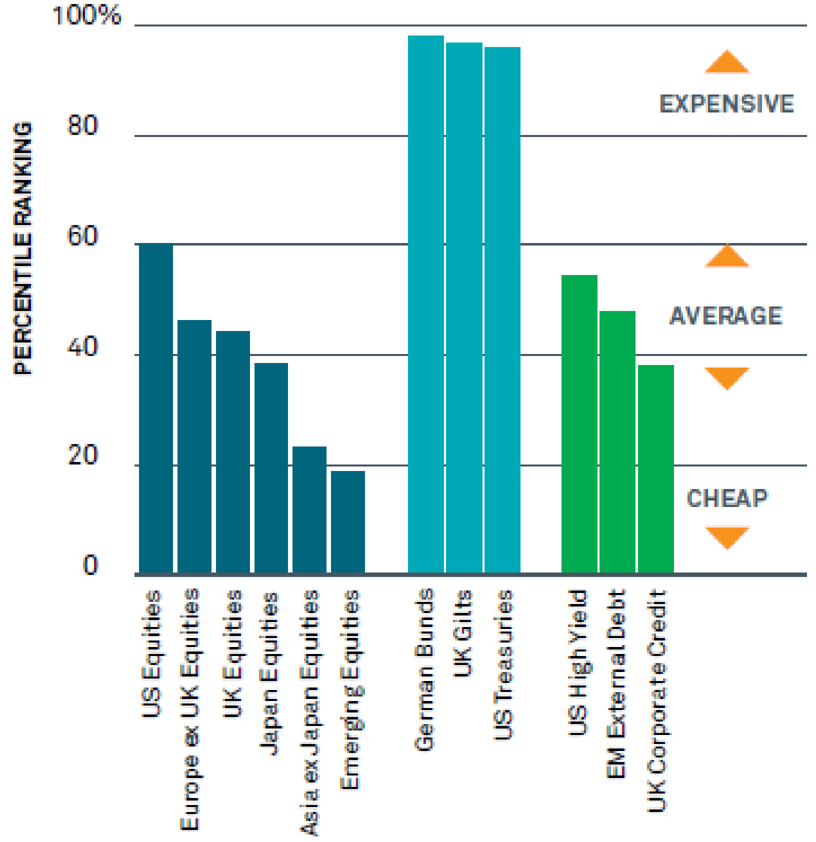
	YTD RETURN	CURRENT YIELD	SAFETY CUSHION (BASIS POINTS)	PEAK-TO-TROUGH RETURN	YEARS OF YIELD TO RECOVER
US TREASURIES	-2%	1.2%	23	-3%	2.5
GERMAN GOV'T	-1.5%	1.1%	16	-2.7%	2.5
JAPANESE GOV'T	0.4%	0.7%	9	-3.5%	4.9
ITALIAN GOV'T	1.9%	3.6%	61	-3.3%	0.9
SPANISH GOV'T	4.5%	3.8%	71	-4%	1.1
UK GILTS	-2.6%	2.2%	23	-4.9%	2.3
EM GOV'T (LOCAL)	-7.2%	5.6%	114	-10.5%	1.9
EM GOV'T (USD)	-6.9%	5.1%	73	-7.8%	1.5
US CORP	-3.3%	3.3%	48	-5.3%	1.6
US HIGH YIELD	1.7%	6.6%	149	-3.8%	0.6
UK CORP	0%	4.1%	53	-5.2%	1.3
EURO CORP	0.2%	2.3%	52	-2.1%	0.9
EM CORP (USD)	-4.5%	5.8%	113	-6.3%	1.1
US CMBS	-1.1%	2.3%	70	-2.5%	1.1
US MBS	-1.9%	3.1%	60	-2.4%	0.8

Sources: BlackRock and Barclays Capital, June 20, 2013.
Notes: The safety cushion represents how large a yield rise (in basis points) would trigger a price decline that would wipe out one year's worth of income. Years of yield required to recover from peak-to-trough loss assumes constant prices and is for illustrative purposes only.

Eye of the beholder – most assets are still priced reasonably compared with their own history. Safe haven government bonds are the exception.

- Safe haven government bonds are expensive!!
- Equities offer some reasonable upside with variations between regions.
- Some areas of credit and emerging market debt also offer the prospect of some upside.

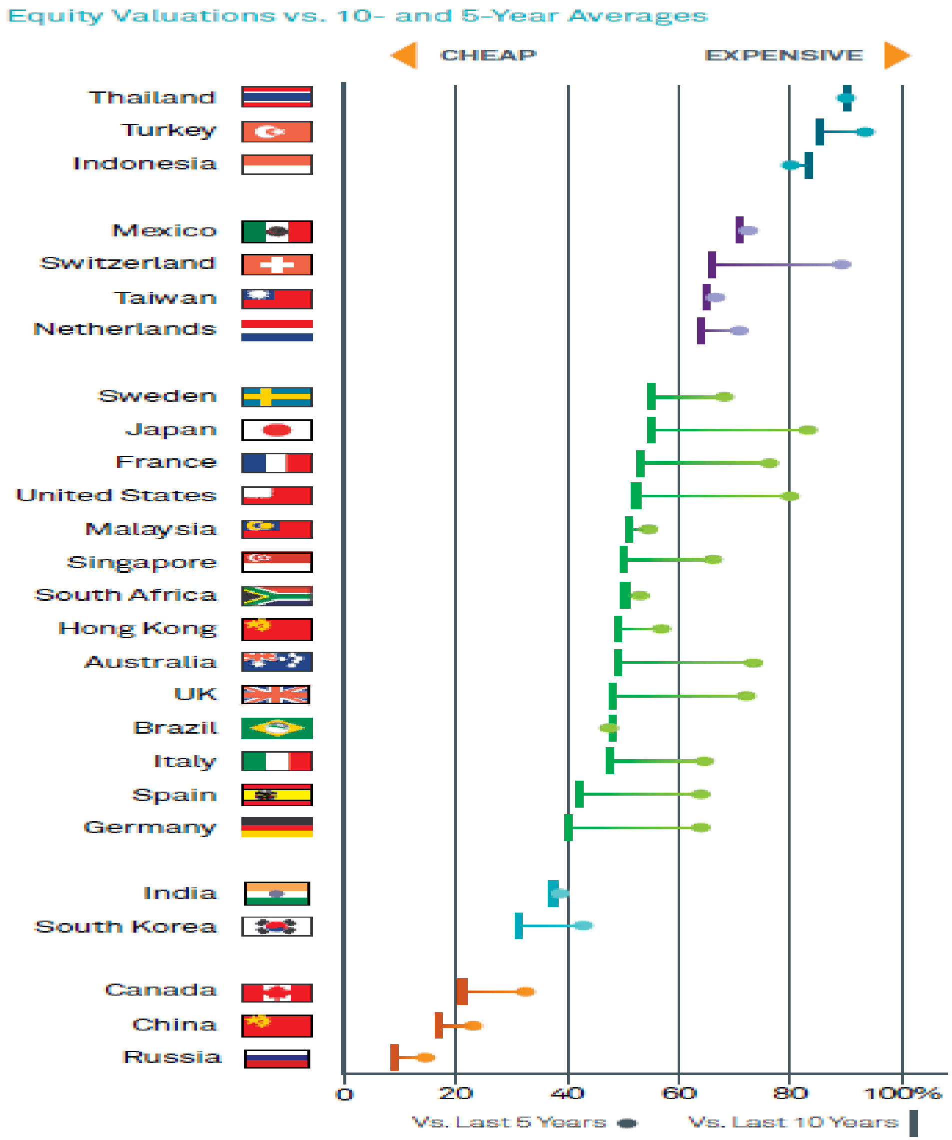
EYE OF THE BEHOLDER
Valuations by Percentile vs. Historic Norm



Sources: BlackRock, Thomson Reuters and Bloomberg, June 2013.
Notes: Time periods range from seven to 30 years. US Treasuries, UK gilts and German bunds represent the real yield. Equity valuations based on average of dividend yield, book values and price/earnings ratios.

World stock inequality

Most equity valuations look reasonable. Notable exceptions in South East Asia and Mexico.

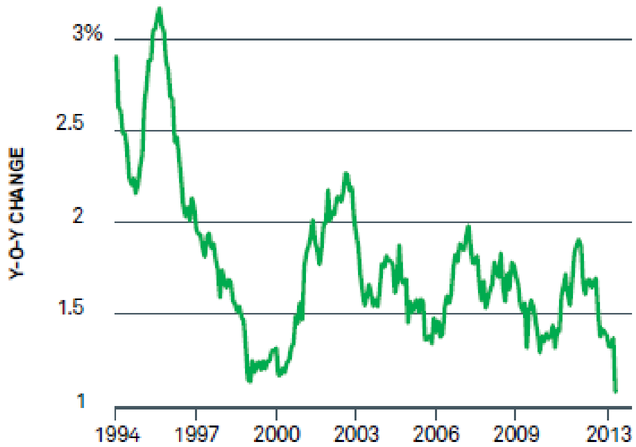


Sources: BlackRock, MSCI and Thomson Reuters, June 2013.
Note: Current percentile rankings versus the average of price to forward
earnings, price to cashflow, price to book value and dividend yield in the past 10
and five years.

Real rates riddle…..benign or malign?

DEFLATION DEMON

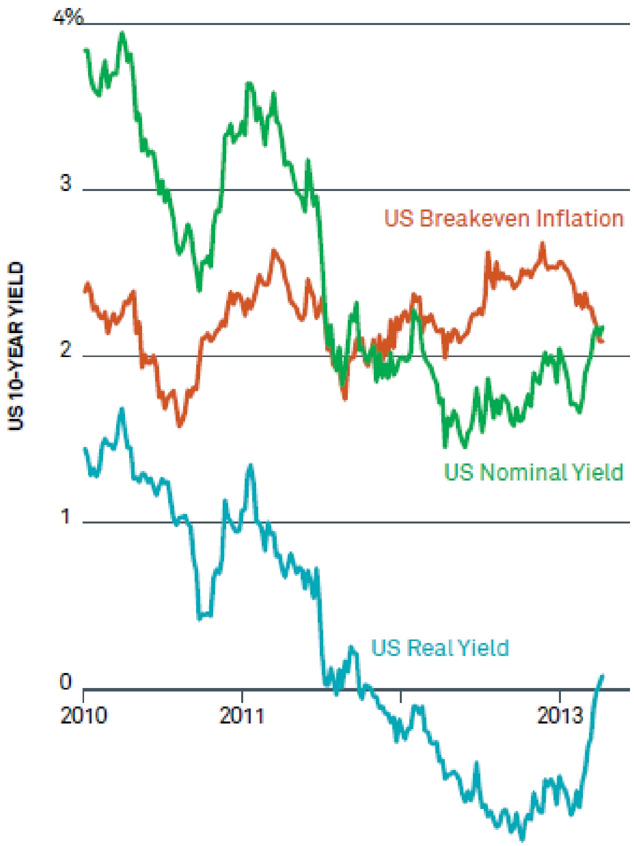
Core Inflation in G7 ex-Japan, 1994–2013



Sources: Thomson Reuters and OECD, June 2013.
Notes: Core inflation excludes food and energy prices. The measure is an equally weighted average of the United States, UK, France, Germany, Italy and Canada.

REAL RATES = REAL RISKS

US Real Rate Breakdown, 2010–2013



Real rates are key to watch in the second half. It is okay if they go up modestly because of a strengthening growth outlook. This would likely be good news for equities. It is not okay if the primary driver is (a fear of) deflation.

Emerging Strains

WHAT GOES IN…

Emerging Market Portfolio Inflows, Bond and Currency Markets, 2009–2013

		CHINA	INDIA	INDONESIA	S. KOREA	PHILIPPINES	THAILAND	HUNGARY	POLAND	RUSSIA	S. AFRICA	TURKEY	BRAZIL	MEXICO
EQUITY PORTFOLIO INFLOWS	Billions	$183	$76.5	$4.7	$57.7	$1.7	$9.4	$1.4	$17.1	$-8.6	$8.8	$12	$87.6	$6.7
	% GDP	2.2	4.1	0.5	5.1	0.7	2.5	1.1	3.5	-0.4	2.2	1.5	3.9	0.6
BOND PORTFOLIO INFLOWS	Billions	$64.5	$14.8	$39.3	$87.2	$3	$20.9	$4.6	$63.3	$33.6	$34.7	$70	$64.9	$167.9
	% GDP	0.8	0.8	4.5	7.7	1.2	5.7	3.6	12.9	1.7	8.8	8.9	2.9	14.3
FOREIGN BOND HOLDINGS	Billions	NA	$15.3	$29	$55.6	NA	$18.4	$20.4	$63.3	$8.5	$37.5	$59.1	$138.1	$95.9
	% of Total	NA	2.7	32.6	16.1	NA	17.6	40.7	36	7	36	26.7	14.8	58.2
INT'L RESERVES	Billions	$3,443	$259	$105	$328	$83	$166	$46	$101	$480	$41	$109	$376	$167
	% GDP	41.8	13.9	12	29.1	32.3	45.1	36.5	20.5	23.9	10.4	13.8	16.6	14.2
FX DAILY TURNOVER	Billions	$20	$5	$1	$6	$1	$1.1	$5	$6	$7.5	$7.5	$11	$15	$15
	Days to Exit	NA	3.1	29	9.3	NA	16.7	4.1	10.6	2.4	6	5.4	9.2	6.4
FX VS. USD	% 2013 YTD	1.7	-2.9	-1.9	-5.4	-4.6	-0.4	0.7	-2.6	-5.4	-15	-5.3	-5.8	0.9
	% Since S&P Peak	0.2	-1	-1	-1.3	-3.9	-2.9	3.7	2.7	-1.5	-3	-1.1	-5.3	-2.8

Sources: Bank of America Merrill Lynch and Thomson Reuters, June 19, 2013.

Notes: Portfolio inflows are gross aggregates from Q2 2009 to Q4 2012. Foreign bond holdings are as of March 2013 and taken from domestic central banks. International reserves as of March 2013. FX daily turnover data taken from the 2010 BIS Triennial survey. Days to exit represents the number of days it would take foreign bond holders to sell their holdings at the daily FX turnover rate. The S&P 500 peak was on May 21, 2013.

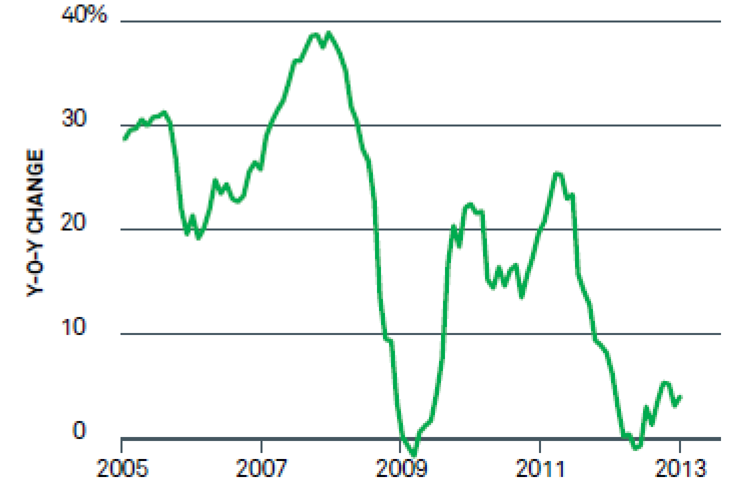
Emerging markets funding strains

Growth in emerging market foreign exchange reserves has been strong.

Funding strains are the result of both internal weaknesses (some countries had been waving the red flags of rapid credit growth and worsening current account deficits) and fears of an abrupt end to the era of easy money (which underpinned emerging currencies and ever-lower debt yields). The self-inflicted wounds are real, we believe, but fears of a 1997–1998-style funding crisis are overdone.

STASHING AWAY LESS

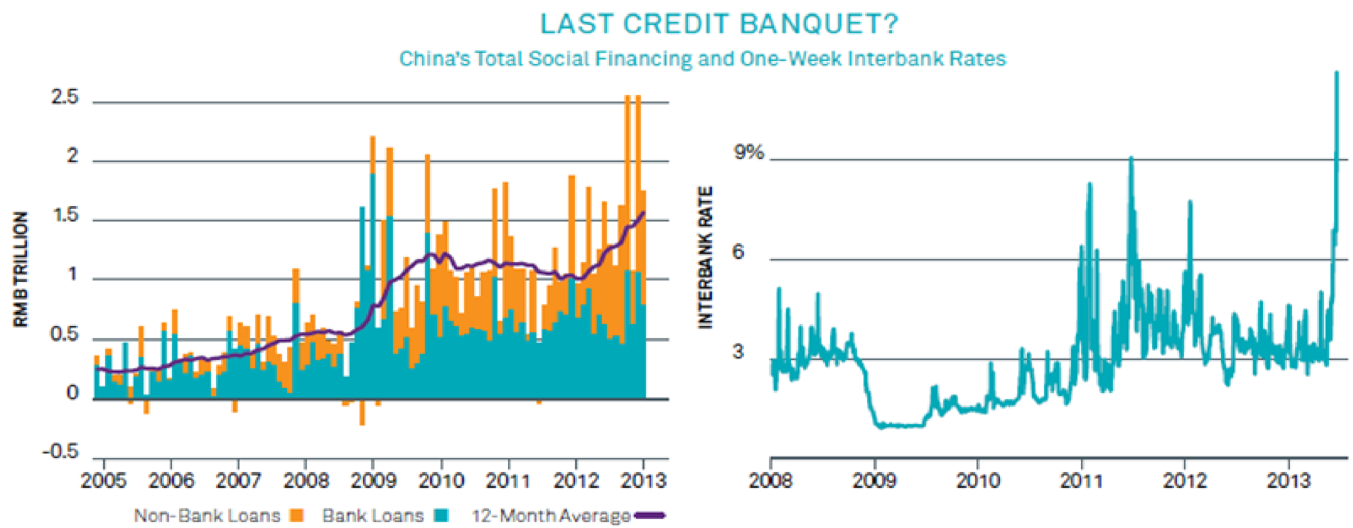
Growth in Emerging Market Reserves, 2005–2013



Source: BlackRock Investment Institute and Thomson Reuters.
Notes: Countries included are Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, South Korea, Malaysia, Mexico, Peru, Phillippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey. Data through March 29, 2013.

China: the last credit banquet?

- China is a credit-hungry dragon – and the cut off from external credit markets and tighter domestic credit will slow economic growth.
- Beijing has deep pockets (a $3.4 trillion FX reserve kitty) and a closed (although increasingly leaky) financial system. A popping of China's credit bubble would not pose a systemic risk to the global financial system.
- In the case of a crisis, China is almost certain to bail out and recapitalise its banks. It has done so before.
- Regulators are not asleep at the wheel.
- Further rises in interbank rates would be a warning sign for a real liquidity crunch.
- Do not expect a monster fiscal stimulus. China's new leadership appears willing to tolerate slower growth if it helps rebalance the economy toward consumer spending. The new leaders are in no great hurry: They are appointed for a decade.



Sources: Thomson Reuters and People's Bank of China.
Note: Data on left chart through April 15, 2013; on right chart through June 20, 2013.

4. The rest of 2013: Scenarios

2013 Scenarios: Still a favourable backdrop for risk versus defensive assets

SCENARIO	ASSETS	SIGNPOSTS
Stop 'N Go **25%**	• Correlated and volatile rallies dominate trading. • Super short– and super long-term strategies. • The hunt for yield favours dividend stocks, high yield and other credit. • Defensives trump cyclicals.	• Scattershot growth. • Money multipliers that show no sign of responding to monetary stimulus. • Haphazard and reactive policies that fail to stimulate real growth and achieve sustainable debt levels. • Correlations rise and returns on risk fall.
Nemesis Redux **15%**	• The usual suspects of cash, US Treasuries, German bunds, the Japanese yen, US dollar and gold. • Investment grade credit should do relatively well. • Volatility is still low, so protection is pretty cheap.	• Real interest rates rise quickly – for the wrong reasons (the prospect of deflation or emerging market selling to prop up local currencies). • China's economy implodes. • The ECB's pledge to preserve the Eurozone is tested. • Correlations, volatility and investor blood pressure soar.
Go Growth **15%**	• A massive risk-on rally, with funds parked in cash, fixed income and quality stocks flowing to risk assets. • Commodities and oil should do well.	• Signs monetary stimulus is working in bank lending. • Sell-off in short bonds for the right reason (growth). • Europe and Japan enact labour reforms and industry deregulation. • Low correlations but a mild rise in volatility.
Age of Separatism **40%**	• Equities look better and less risky than fixed income assets. • Relative value investing and security selection. • Shift gradually from income investing to assets geared toward growth (cyclicals).	• Correlations between asset classes further decline. • Effectiveness of monetary and fiscal policies of individual countries. • Policymakers keep Nemesis events (see above) at bay.
Inflate Away **5%**	• Commodities, gold and hard assets such as property tend to offer some protection. • Sell low-yielding government bonds and other fixed income. • Cash is a (not so silent) savings killer.	• The Fed inflates asset prices to bubbly proportions. • The ECB joins the global QE party. • The developed world runs up huge deficits – but fails in structural reforms to spur growth and create sustainable budgets.

Perhaps the only thing we have to fear is fear itself.

Disclaimer

Important Information