Royston Capital
AFSL 438262

Economic Update

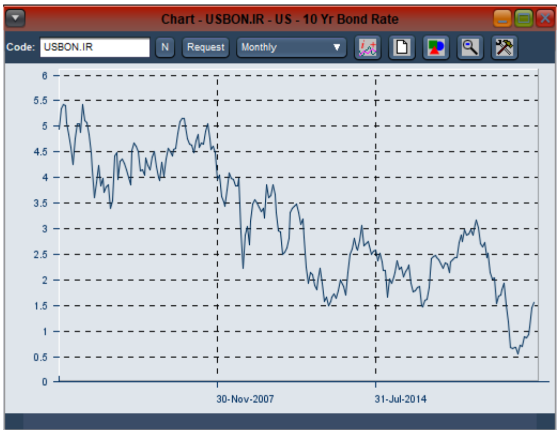
The Recovery Continues

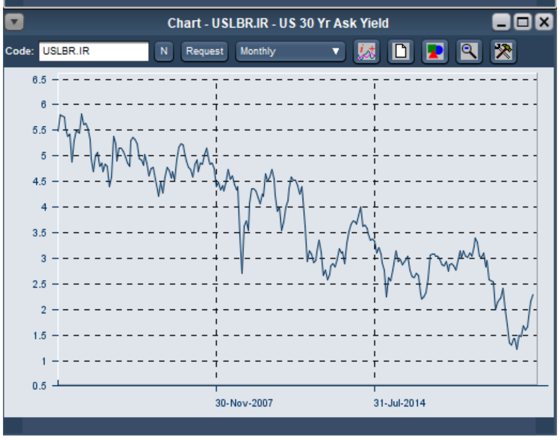
March 2021 edition, By Chris Boag

With a swathe of good news coming from a variety of economic indicators we have seen global equity markets continue to rise. The vaccine rollout continues to be a focus for investment markets despite the patchy and limited rollout to date. Global economic activity looks certain to continue to recover during 2021 and 2022 providing markets and policy makers plenty to consider. A strengthening world economy is supportive of equity valuations but is a negative for bonds and other fixed rate income investments where the prospect of higher inflation has caused bond managers to fret. Regardless, GDP and many other metrics are all pointing in the right direction and we are seeing a 'V' shaped recovery. As the recovery continues, we will see some of last year's dislocations in investment markets rebalance throughout the year.

In a recent sector review from research house Morningstar, I couldn't help but notice the major bond mangers were almost all experiencing negative returns over 1yr and even 3yrs. Over the past few years, notably since the GFC, bond managers have had to deal with negative interest rates for the first time in history. The primary objectives of buying a bond are to profit from the income and receive capital stability through almost certain repayment of your initial capital outlay at the end of the set term. Negative interest rates however have led bond managers to switch to profiting from capital gains as bond prices continued to rise (yields falling). As bond markets become volatile with the push and pull of looming inflation expectations, many bond managers have been caught out playing a high-risk game. Those invested in floating rate securities are far less impacted as noted with the Royston Capital Interest-Bearing Securities Portfolio performance.

As I said in last month's update, "As positive economic growth fundamentals assert, bond yields will continue to rise. The RBA will not want longer-term bond yields to rise too fast, but it is one of a range of problems the RBA faces as it tries to keep interest rates low to assist economic recovery."……"While short term the rates have increased, they are yet to break out of a long-established down trend. No cause for great concern yet." The rise in bond yields has taken a pause for now and this caused further volatility in investment markets this week (charts updated from last month). Despite the pause in bond yields we are still seeing a rotation away from a select group of technology companies that most stock analysts would say are significantly over valued. Our colleague, David Steinthal is promising to write an in-depth article (aka, a takedown) on value v's growth discussions. I look forward to reading his hopefully scathing and entering review and will share it if I can.





The late February bond market sell-off has been compared to that of 1994, however it is different in that the bond market sell-off then was triggered by interest rate rises by the US Federal Reserve to contain growth and inflation. The central banks and the bond market were on the same page. Both saw an inflation threat that needed containing. This time the bond market and

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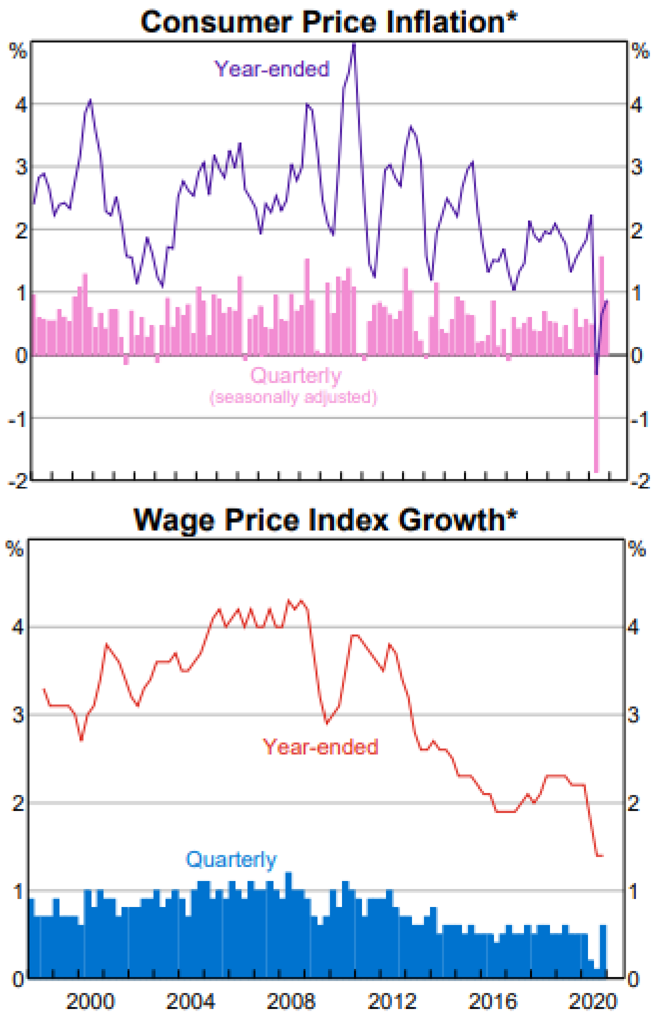
central banks are at odds about inflation risk. We see central banks backing their view of persistently low inflation.

The RBA held its meeting earlier in the month and confirmed no interest rate increases on the horizon. The RBA is seeking inflation to be firmly in the 2-3% range before making a move. “For this to occur, wages growth will have to be materially higher than it is currently. This will require significant gains in employment and a return to a tight labour market. The Board does not expect these conditions to be met until 2024 at the earliest”.



* Total pay excluding bonuses
Source: ABS

The RBA needs to retain a very dovish stance at this juncture so that both actions (yield curve control (YCC) and QE) and words (central bank communication) are pulling in the same direction. The last thing the RBA wants to do right now is sound more hawkish than it previously has given that will only be interpreted as validating the selloff in bonds. In turn that would put upward pressure on interest rates and make it harder to defend the 0.1% target on the 3-year AGCB. In addition, it would put unwanted upward pressure on the Australian dollar. The other point to note in Governor Lowe’s statement was around the housing market. Lowe note that, “housing credit growth to owner-occupiers has picked up, but investor and business credit growth remain weak. Lending standards remain sound and it is important that they remain so in an environment of rising housing prices and low interest rates”.

No doubt as we continue down the recovery path, supported by government fiscal spending and ultra-low interest rates, we will see bond markets continue to fret over inflation risks. We will see push and pull from bond markets, central banks and government spending, overlaid with news of the vaccine rollout. The 2nd half of the year is shaping up to be very interesting for this tug-of-war and eventually central banks and governments will need to amend their policies. The Royston Capital Model Portfolios are positioned for any rotation in equities as we too don’t have a view on value v’s growth but instead focus on buying quality businesses at an attractive price that are growing. Is that value or growth……. I’m not sure?

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Sources: Commbank Global Markets Research, RBA, Morningstar, Alexander Funds Management.