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Markets

Bond market vigilantes find their voice

Jonathan Shapiro and Vesna Poljak

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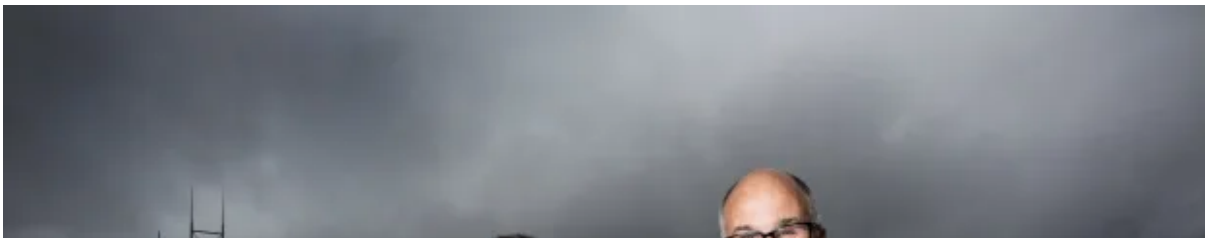
A veteran investor who witnessed the bond market crash of 1994 agrees 2018 could deliver a similarly nightmarish scenario if the US Federal Reserve is caught chasing inflation and has to raise rates too quickly.

Ellerston Capital's Brett Gillespie was "fairly bearish"; his core forecast has Treasuries at up to 3.5 per cent with no boom in inflation. That alone would not be enough to upset the equity market unless it happened quickly, he told the Portfolio Construction Forum Markets Summit 2018 in Sydney on Tuesday.

"Where we differ a lot to consensus is the restoration of 10-year risk premium" Mr Gillespie said. "The effect of [quantitative easing] on the long end of the market has been to suppress that risk premium on the 10-year down to about 15 basis points, even zero, at some stages. We think that's going to get restored much quicker than the consensus."



Brett Gillespie (right) and Tim Toohey from Ellerston Capital. **Jessica Hromas**

For that to escalate, it would take a sharp pick-up in wages and a severe market response. There is a "one-third" chance that the Fed gets behind the curve, causing a recession, and funds have to deleverage in response by selling bonds.

"Rather alarmingly, we've just seen a big expansion in the fiscal deficit by Trump. As we came into this year we got the tax package passed, that was a half per cent fiscal stimulus to the economy this year," Mr Gillespie said. A further $US320 billion has been added in defence spending.

"Not only do you not have central banks purchasing, you've got an extra $US50 billion of Treasuries being issued [monthly] to the market," he said. "It's a dramatic shift and this is what's getting the bond yields unhinged."

He disputed the trigger for the sell-off was the wage inflation figure of two weeks ago.

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Mr Gillespie speculated what it would take to revisit 1994, when yields on 30-year Treasuries rose by about 200 basis points in the first nine months of the year

There is a "one-third" chance that the Fed gets behind the curve, causing a recession, and funds have to deleverage in response by selling bonds. **Richard Drew**

"This is the really big risk for the market because in the past when you've been this far through NAIRU [the non-accelerating inflation rate of unemployment] interest rates in the US have already been at neutral or higher. That would mean today 3 per cent, 3.5 per cent. Getting a wage spurt now when you don't have interest rates at 3, 3.5 per cent, that's when you say the Fed's behind the curve and that's when the market panics."

In fact, "I don't think they're going to be super aggressive this time, I don't think that's their mindset," Mr Gillespie said of the US central bank. "Even if the Fed chooses to slow down its rate hikes, it's not going to calm the long end."

Mr Gillespie and Ellerston economist Tim Toohey have been vocal about the prospect of a bond correction since launching their fund a year ago.

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The dominant theme at the annual conference was whether the prospect of rising inflation and the retreat of global central banks represented a paradigm shift.

David Rowe

For advisers, their dilemma was whether or not to increase, or decrease, their exposure to bonds that have proved a reliable asset class. Other presenters questioned the role of bonds as an effective diversifier.

Gopi Karunakaran of fixed income fund Ardea Investment Management believed that bonds may no longer be a defensive asset class or provide adequate diversification from equities. Historically, fund managers could count on bonds rising in value when shares fell. But the market correction that began two weeks ago caused bonds and equities to sell off sometimes in tandem.

Mr Karunakaran said the lack of a "term premium" meant that bond investors were not being adequately compensated for the uncertainty and the risks they were facing.

"Whether you believe we are in a prolonged period of low inflation or not, it's already priced into markets."

Mr Gillespie and Ellerston economist Tim Toohey have been vocal about the prospect of a bond correction since launching their fund a year ago. **Jessica Hromas**

He said while factors such as technology, globalisation and demographics had been used to explain low inflation, they were just arguments. "There's more uncertainty than certainty about why inflation will stay low."

The actions of central banks in scaling back asset purchases "will be one of the most important things to watch", Mr Karunakaran said.

"Based on explicit guidance from the US Federal Reserve and some hints from other central banks, it's quite possible 2018 will be the first year since the global

"The base case for rates to stay where they are even as central banks withdraw stimulus is that they will do so very slowly without disrupting markets – that is all contingent on not having an inflation surprise."

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Federal Reserve chairman Jay Powell was sworn in last week as Janet Yellen's successor. The next test for inflation comes on Wednesday in the US when January's consumer price index data is released.

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