PORTFOLIO ADVISORY

PAS Insights April 2022

Rate hikes on the horizon

Global bonds have faced terrible start to the year. The 6.2% decline **in** the Bloomberg Global Agg index is the worst start to the year since we have data from the early 1990s. And it is the third worst quarter on record since then. In Australia, the broad Australian Composite index has experienced its worse quarter, falling 5.9%.

Chart 1: Low returns over the past 12 months have reduced long-term returns

	1 month	3 month	6 month	12 month	3 year (annualised)	5 year (annualised)	10 year (annualised)
BBG Global Agg	-3.0%	-6.2%	-6.8%	-6.4%	0.7%	1.7%	1.0%
BBG Aus Composite	-3.7%	-5.9%	-7.3%	-5.5%	-0.3%	1.9%	3.4%
US Treasuries	-3.3%	-5.8%	-6.5%	-6.5%	0.4%	1.5%	0.4%
BBG Global Corporate	-2.7%	-7.7%	-8.1%	-6.7%	1.6%	2.5%	2.4%
BBG Aus Corporate	-3.6%	-5.5%	-7.1%	-5.6%	1.0%	2.6%	4.4%

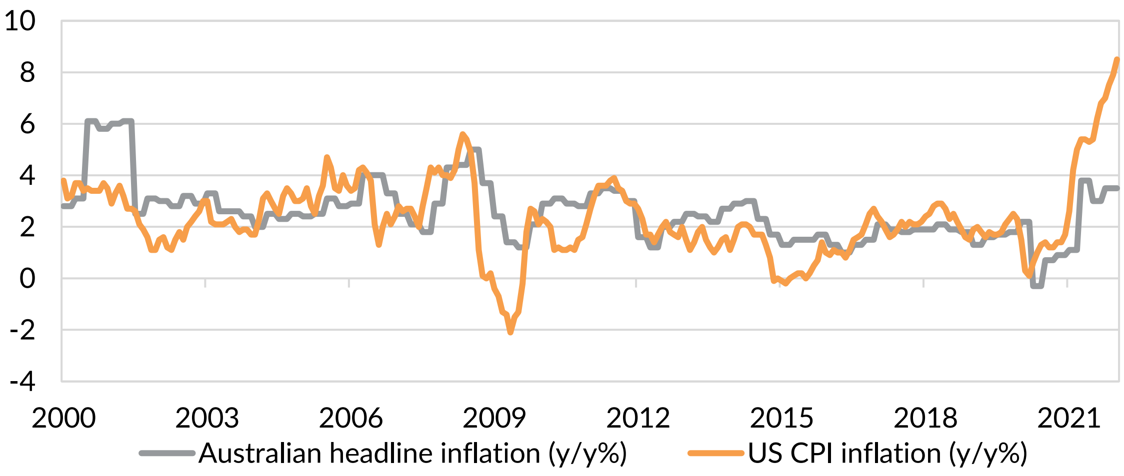
Global central banks have started hiking rates. That has pushed yields higher. It is a challenging time for the asset class many investors define as “Defensive”.

There are more hikes to come

Markets are currently pricing a Fed Funds rate of 2.4% by year-end. In Australia, the markets expect a 2.0% cash rate. These are eye-watering numbers. Around eight 0.25% hikes from both central banks.

The central banks are hiking in response to higher inflation. Higher inflation reflects a combination of supply side disruptions – from Covid19 and the war in Ukraine – that are proving more persistent than the banks hoped. There are also second order impacts. Wages are being bid up in both the US and Australia.

Chart 2: Inflation is above the central bank target in the US and Australia.



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Higher rates, slower growth

The Fed and the RBA aim to slow growth. But growth is slowing already. Inflation likely peaked in April and is trending lower. The uncertainties surrounding the war and Covid continue. Growth is going to slow further.

The central banks will hope for a soft landing. One where growth returns to trend. Inflation reverts to target. The unemployment rate remains near full employment. This is difficult to achieve. Probably impossible if rates are hiked 8 times between now and December.

Expectations matter

The Fed and the RBA want to control inflation expectations. Talking tough allows them to do less later on. And they know monetary policy works with variable lags. Hiking this year will impact growth next year – and slower growth and inflation is already baked in.

We expect both central banks to hike but to keep an eye on inflation expectations. As inflation expectations slow, the tough talk from the central banks could begin to ease.

What does this mean for bonds?

The pain felt by investors in bonds is unusual for most who have only ever experienced a bull market. Allocations held now and for new clients are understandably difficult to justify.

We think the starting point is your investment philosophy. The following questions have been helpful for our clients.

- What is the risk tolerance and time frames for your investors?
- What asset classes can they invest in?
- Are you an SAA only portfolio, or do you typically engage in active/tactical changes?
- What is the role of fixed income in the portfolio?

For the last question, that role could include diversification, downside protection, income, capital gains, and capital preservation. We have been helping some of our clients work through these and in some cases have made changes. In others, the investment philosophy resulted in portfolios being largely unchanged.

We are happy to work with you and your investors to workshop these issues and respond within a clear, repeatable investment process.

Contact PAS for more information.

The Portfolio Advisory Service has been working with clients across Australia and Asia to help manage investment solutions. This includes a clear move towards managed accounts within the Australian and Hong Kong markets, as well as a focus on investment governance and investment process. The Portfolio Advisory Service can help build custom-made investment solutions including managed accounts, or by providing access to our own range of Active Alpha, Active Beta Plus and Active Beta portfolios. Our work is supported by deep asset class research and manager review expertise within the team – delivering great outcomes for our partners.

Reach out to our Portfolio Advisory Service to find out how we can assist you with managing your investment challenges.

E portfolio.advisory@oreana.com W portfolio-advisory.com