Martin Bros

MONITOR

Creating Long Term Financial Success For Our Clients

Welcome to the June 2015 Edition of the Martin Bros Monitor.

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Is The Chase For Yield Over?

The last six weeks have been a turbulent time for equity markets with the benchmark ASX200 falling approximately 9% over this time before recovering over the last few sessions. In our June 2014 edition of Martin Brothers Monitor (MBM) we wrote a piece titled “Where’s the Volatility”, about the benign market conditions that we had experienced for the last year or so where any sell offs were short in duration and shallow in magnitude.

Since this time we have now had three sell offs of between 7 – 9%, including the most recent one. This type of sell off is customary in an otherwise bull market cycle, which you would have to describe the last three years as being. Each time there is a sell off of this magnitude, it is usually over a short space of time. In industry terms this can colloquially be described as “equity markets going up the escalator and down the lift”. When you are in the midst of a sell off it can often feel a lot worse than it is. In our March edition of MBM we wrote that this type of fall is often preceded by a sharp run up in the market. This was again the case.

Over the last few years we have written about the yield from equities supporting share prices and sending them higher due to a period of low, and going lower, interest rates around the world. This has resulted in a chase for yield as all things with a market linked interest rate setting, such as bonds, term deposits etc., were falling in yield. Over this same period we have consistently warned about a growing “Bond Bubble”. This is where global bond yields have been bid down to never before seen yields; some into negative territory, as trader’s front run the Quantitative Easing (QE) program of Central Banks around the world. We have warned that at some point the direction of these Bonds must revert to more normal levels (which commonly is regarded as a countries GDP plus inflation).

As yields rise, the value of Bonds decreases. Existing holders will experience a capital loss. If this capital loss is greater than the interest rate, then they will have a negative return. It seems improbable in a fixed interest bond fund but returns can actually be negative. We suspect many people are not aware of this and at some point they will receive a rude shock, after several years of stable returns, they could be in for quite a tumultuous few years at some point. With global government bond yields anywhere from negative to 3.0% (Australia is virtually the highest yielding of developed countries), you can see how little capital loss (rising yields) you need to create an overall investment loss if you are only receiving 1, 2 or 3% income annually. As a guide, a bond with 10 years to maturity, that is currently yielding 3%, will suffer an approximate 8% capital loss if that yield goes to 4% (a 1% rise). For the same 1% increase in bond rates, the volatility is even greater on lower yielding bonds (eg. one yielding 2% now).

In our March 2015 edition of MBM we included a table of the current 10 year bond yields for eight of the major developed economies around the world, including Australia. We noted that long dated bond yields will rise well in advance of official (short term) cash rates. Below is the same 10 year bond yields we published in March with their respective yields then and now.

Country	Bond Yield – March 2015	Bond Yield – June 2015
USA	1.91%	2.36%
Australia	2.36%	3.02%
United Kingdom	1.59%	2.05%
Germany	0.19%	0.88%
France	0.47%	1.22%
Canada	1.32%	1.81%
South Korea	2.26%	2.47%
Japan	0.35%	0.49%

The relative sharp jump in global bond yields is arguably what triggered the recent sell off in equities, particularly in Australia that is seen as a high yielding equity market. Other factors have also contributed to a broad sell off in Australian equities which include the recent large Rights issue by NAB (people sell other shares to fund the take up of their rights) and global hedge funds shorting Australian yield stocks to use the funds for rotation into Asian stocks.

The latter two are short term issues which will not cause a longer or deeper sell off. The rise in bond yields will cause volatility and we suspect this will be the trigger of future equity market sell offs over the coming few years. Does this mean the yield trade is over though? We think not. Not yet at least. Rising bond yields will eventually lead to a period of equity market under performance. But yields on Bonds are still so (historically) low and likely not rising significantly in the short to medium term. The US seems to be the only developed country contemplating raising short term interest rates for at leas the next year. Many countries likely have further short term interest rate cuts to come, possibly including Australia.

As we noted, long bond yields will rise well ahead of official short term interest rate increase. With so much of the world holding historically low interest rates and even cutting further (or undertaking QE programs like Europe and Japan); long bond yields should take some time to normalise. This normalization will not be smooth though, and each time we see sharp short term rises in bond yields, equity markets are at risk of falling during this time. These falls though should be limited to standard equity market corrections (less than 10%). The yield trade is still alive. Buckle up for more volatility, as we warned last year. But this is nothing to be afraid of. If anything, it will create some opportunities along the way.

Make Your Concessional Contributions to Super Before June 30

A reminder of the concessional contribution limits for the 2014/15 financial year are listed below. Concessional contrbutions include any Superannuation Guarantee (SG) paid by an employer on your behalf as well as salary sacrificed amounts.

Concessional Contributions (deductible) for the 2014/15 Financial Year

- Up to age 75 - If over 65, must meet work test
- If employed (i.e. not self-employed), contribution must be made via employer.
- Limits are as follows:
  - Up to age 50 (born after 30/06/1965) $30,000 per annum per person
  - Age 50* and over (born before 01/07/1965) $35,000 per annum per person

** Individuals aged 49 as at 30 June 2014 are eligible for higher limit*

The above rates will also apply in the upcoming 2015/16 Financial Year.

Please contact us should you wish to discuss concessional contributions or anything else contained within this edition of the Martin Bros Monitor.

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