**Volatility in Markets: When will it end?**

**NAB Business Markets Podcast – February 2016**

Host: **Peter Hartley** – Business Markets Foreign Exchange (PH)

Speaker: **Mark Todd** – Director Capital Finance (MT)

PH: Hello and welcome to the February 2016 edition of the NAB Business Markets Podcast. I’m Peter Hartley and we’re joined today by Mark Todd, from Capital Finance. Mark, thanks for joining us.

MT: Thanks. How are you?

PH: Very good. I see you’re looking well.

MT: I am doing my best for an ageing person, but that’s alright.

It’s been a volatile market which makes me age a little bit. Because you look at markets and try to understand what’s going on and I must admit, I had a Christmas break and they had a Christmas rally in equity markets and everyone was happy. The Fed had got their first hike out of the way, first in 8yrs and there had been, you know a lot of dissent around whether they could get it done and everything seemed positive. You go away for a few weeks and you come back and the volatility in the market has been utterly surprising.

And the losses, when you go and talk to people about what’s happening in the more volatile asset classes, like equities, the losses are really concerning, because it affects the way that people start thinking and it affects confidence and that’s one of the things the US Fed (Stanley Fischer) Deputy Chair for the US Fed, he spoke about that in the last week or so. Saying that they are looking for the impact of changes in prices of assets that you buy and sell, (so the stock exchange), and how it plays out from that, which is Wall street to Main street. Does it affect behaviour in the US? It would be hard to imagine over time how it doesn’t affect people to see that level of volatility, and to look at what’s happening with different assets that you might own. I think that’s a challenge for policy makers, but the thing that really blew me away is that you couldn’t point to a reason why markets were sold and I think a lot people back fill it with ideas that it’s oil, we talk about that if you like.

But it is really interesting, that you couldn’t really put your finger on it and say that’s the reason for the sell-off, other than the fact that everyone is long and it is hard to work out when markets go and you start to get nervous.

PH: So the ASX lost $40 billion yesterday and we’ve seen the Chinese stock exchange down by 20% year to date, are you thinking this is mainly oil driven or are we looking at more of a banking issue where people are worried?

MT: I think that the Chinese are probably happy that it’s New Year and they are on holiday and they don’t have to look at it. For a lot of the investors, it’s sometimes better to not look at it, because it is not logical and they seem to have captured this idea about oil being the driver. It’s lost to me that the oil price going low is not seen by anyone as a positive. If you fill up at bowser, if you buy something that needs a driver to use oil, so it should be reducing some of the cost, if you’re running a farm it should become a bit cheaper. Travel should become cheaper on planes, because there should some benefit. No one ever speaks to the benefit of a lower oil and I think the concentration on oil, is all around the producers, but the truth of the matter seems to me to be all about the supply, you know Iran is coming on. I don’t believe for one minute that there will be a coalition on the supply side, I don’t feel they can afford to agree to limit the amount of the supply, I just don’t see that ever happening. I think there are too many parties, with too much self-interest. It’s a supply side and I think a lot of the equity market is trying to justify it in hindsight, but it is very important in my mind that you saw the movement by the Bank of Japan when it came to changing its base rate for excess cash to minus 10 basis points. That was the first thing to say to me, that the challenge is that markets are talking about, central banks are addressing around how do they stimulate their economy and I think that was the most concerning and that has ramifications. We’ve spoken about this, there’s now trillions of dollars at negative interest rates globally.

PH: Yeah you’re right 7 trillion dollars or 25% of the world’s bond market with negative yield.

MT: Yes. Because some of the bond market is structural, if you’re a pensioner fund you need to own these sorts of assets. You can’t really just go out and buy anything you like it’s the mandate of where you are, you have to provide annuities, you need to find a component. If you’re a bank you have to buy these very conservative assets. So that ramification starts to play out in a lot of asset classes, everyone’s characterised it as a chase for yield, but it’s not just the chase for yield. You are hamstrung about what you can go buy in certain business and they have to buy this debt. The central banks aren’t worried about the short term, they’re more worried about pretty much where the currency goes. I think it’s more of a currency story and they’re trying to use these policies to stimulate the economy by a lower currency. That’s a net sum game and it is quite hard to work out the end game.

PH: So two questions on Japan then. The fact that they have pushed into negative interest rates a week after saying that they won’t do that strategy. Do they lose any future credibility? And the second thing, is does going into negative interest rates on Japanese bonds make Australian bonds more attractive?

MT: I thought one of the themes about the Fed moving in December was about Fed credibility, they said there would be four rate hikes through the course of the year and at some point in time they had to be like look we can absorb it, because we need to be able to say we are in control of the market. Japan making that shift, I haven’t seen an enormous amount of negativity on what the central bank has done. The questions that have been asked of Japan, are about the policies the government has that will support reinvigorating their economy with consideration to their demographics. So the ageing Japanese population is extraordinary. It’s massive. The ramifications are frightening and they don’t have an awful lot of youth coming through to support the ageing population, so how does their economy change? What is the sector that will grow, is it Sony? I don’t know it is Sony anymore, it’s more about longevity industries and if you play out the demographic strategy, it won’t be next week but in decades to come it will be terrible and it will be frightening, and I think that is what everyone is talking about, not the central bank. It’s more about how are you getting women into the workforce, how are you getting foreigners into the workforce, how are you changing your corporate governance? It’s much harder in Japan. Which means that those pension funds that buy (bonds), and a large percentage of the Japanese Government Bonds (the JGBs) are owned by the (Japanese) government. They locally invest. They individually invest. The ramifications are that if you need a conservative asset and you look at Australia, you are familiar with it, you have been buying these assets for a long time. Do you shift the percentage that you buy and look at say government debt and Federal Government debt. If they shift, that’s billions of dollars. There’s so much money in these pension funds that would be a concern because it would affect the currency. Not that people buy our debt, it’s who’s buying our debt. That would be a challenge for our policy makers.

PH: So Mark, you mentioned the US Fed and their discussion about dot points being potentially four more 0.25 point rate rises in the next eight to ten months to take us to the end of the calendar year. Do you think given the Fed will be spending a lot of time now justifying their last rate rise, this will delay them raising interest rates for the rest of this year?

MT: They have said that they will be gradual. And a lot of people of complained about not knowing that it’s gradual. I don’t know that the Fed can give you concrete responses. I think you have to take ownership of your own strategy around what you think is happening. If the rest of the world is going lower, which it is, it just means the limitation is how far the Fed can go. Common sense tells you that. If they went too far, too quickly, their currency would obviously appreciate and that would crimp their exporters and they would suffer, their economy will go backwards. Common sense tells you that is what would happen. It’s about trying to manage this short-term-ism. If I think about the Fed and their March meeting and how they will adjust their settings, I don’t imagine they will say there is more confidence, so there will be more dot points. In other words more people saying that their governing body will go higher, I don’t think they will do that, as that would be a surprise. So there might be an emphasis on being less rate hikes. I think the markets will take that in a very positive matter. It’s not necessarily seen by the Fed as being positive. ‘We can’t lift rates because the market’s too volatile and everything’s not rosy’. That would suggest that you wouldn’t necessarily go buy everything but it is literally the relative value story. Where can I get the sort of returns that I need to live off? I think right now, spreads are high, credit spreads are high. The equities sell off is significant. If the Fed is part of the problem, and they take themselves out of the problem then I think the market will look to try to buy some of these assets. That’s just a guestimate. There is no evidence that they are going to do that yet.

PH: Which leads us to the Reserve Bank (of Australia) and what they are going to do in 2016. We’ve had a look at the market polls at the moment and the surveys from NAB, CBA and Westpac will be flat at 2.00% for the rest of this calendar year. Whereas Macquarie and ANZ are thinking that we might have two cuts over the next six months to take us down to 1.50% for the cash rate. There’s a few international banks that are talking about three rate rises this year, but what’s your feel on what the RBA will do for the rest of 2016?

MT: All due respect to everyone, I just don’t see any rate hikes happening. The RBA is clear that it doesn’t want to move past 2.00%. Its head hasn’t been inclined to say that it can do that. They think that our economy is performing really well, compared to the rest of the world. We have transitioned from the mining to the non-mining sectors very effectively. It has been the benefit derived from the currency. So I think the question around, there’s two points around rate movements. One is what’s happening in the currency, if it continues to stay around these sorts of levels, they would not be wanting to move. That’s the driver in their economy. If it went up, that would put pressure on where rates go. As a borrower and an investor, I think you’ve got to expand your time horizons. When they say we are ‘lower for longer’, you need to define in your mind what longer looks like. I don’t think you will see any meaningful move on the upside in 2016 and I don’t really feel, I don’t know, but it will be interesting to see if there are challenges to moving them up in 2017, because the rest of the world will find it very hard to shift as they’re going lower, to move quickly into going higher. Therefore, if you’re rolling a TD every 90 days, that might suit your cash position and that’s perfectly understandable but if you have too much in cash, just start looking at longer dated alternatives to say that I can put a little bit away to get a much better performance in cash. Because the pressure at the moment is on cash.

PH: The funding costs for banks have been jumping higher in the course of the last month or so and it’s obviously related to banks being nervous about other banks and the ability to repay their debts to each other. Are you seeing funding cost pressures like what’s been announced with banks cutting staff and other costs, is that going to put pressure on our interest rates in 2016 even though the base rates might remain on hold?

MT: So I think the funding story is not so much that banks are worried about lending to other banks I think it’s more about a relative value opportunity. So if bank equity is on the present dividends 8-9% (return), what rate should the senior paper deal at? If it was dealing at +75 basis points spread and equities were at 6%, when equities go to 9%, that 75basis points needs to go higher because of relative value. Everyone thinks in terms of how the capital structure pays. I think it’s more about that rather than a bank not being able to repay its debts. So you extract a higher price in a volatile market. That’s what credit markets do and they are moving that cost out. My overarching view on banks is that the regulatory environment is changing and the goal is to take less responsibility on the public purse to the private purse to fund banks, and that’s via higher capital. Via the obligations of the investor to be engaged in the company they invest in. I think that’s the theme for 2016-2017. About how you manage your capital and how you get good returns on equity. I hear what you are saying in terms of people leaving Australia and job losses, but the emphasis is always going to be on the customer, but in offering the customer the best outcomes, they are going to be looking at in the most productive manner. I think bank employees need to think about how to be productive, in terms of how they service their customer and that has ramifications for everyone. Both the client and the staff member offering the service. I think that doing podcasts and talking to clients is a really good way of showing how productivity works and I think it’s just part of the evolution of the digital footprint of the bank.

PH: The Aussie Dollar. We’ve had a bit of a volatile start to 2016. We were having a look at the forecasts again for the next 12 months AUD/USD. We’ve got a range of banks saying that over the next 12 months we could end up somewhere between 0.7900 and 0.5800 cents. The Aussie banks themselves are talking themselves about somewhere between 0.6400 and 0.7400 cents. What camp do you fall in and what’s your outlook for the Aussie given China, commodities, and the global equity markets?

MT: 58 cents, the outliers are hard to come to grips with why you would have it there. That range tips around 70-69 cents. That feels right. That’s the right number compared to the rest of the world. It is going to be a volatile 2016 in all asset classes, that’s true. The thing that sort of stands out to me is that the US hasn’t really engaged in any part of the currency wars. They haven’t tried to address it. If the US were to change the perception in the market about where their interest rates are going, so they say look we are not going to lift rates for a long time, or the market came to that conclusion. Then it would be easy to understand the market attempting to buy Australian assets, because of our higher relative value to the rest of the world. That would see a rally in the currency, and that would probably bring the RBA into play. I think the RBA will want to try to keep it around these present levels. You’d like to think the RBA is successful in managing the economy and knows price settings. They are a very good organisation the RBA. They’ve been doing a really good job compared to the rest of the world. You mentioned Japan changing their view in a week, you mentioned the pressure on the Fed saying ‘I’m going to lift four times in a year’ and they could only do one. You look at the RBA and they talk about animal spirits and it’s up to you people. It’s actually quite interesting how they’ve adjusted, they’ve looked to the government and said ‘create a fiscal narrative and have a conversation about tax’. The government is now having a conversation about tax. It is something that you could say the RBA has been pretty impressive in the way they’ve managed a pretty volatile experience. It’s been very volatile for years and we haven’t really seen anything to suggest we are going to have a recession. So hats off to them. I think they want it around 0.7000 they may have a bit of luck keeping it around there.

PH: So Mark just to finish up. What ideas do you have for investment strategies over the next 6 months or so for our listeners?

MT: Everyone clearly should define their own strategy for themselves. You have to talk about broad themes. One of the things I’m telling everyone is that money doesn’t sleep so you might as well make it work. Right now the set and forget strategy doesn’t seem to have a lot of support. I don’t know that a lot of people have moved away from the ‘set and forget’ strategy. With rates being as low as they are, it’s all about the granularity. I’m not talking about lots of trading, I’m talking about extracting the best performance for the appropriate risk from your portfolio. I’ll give you an example. A lot of the criticisms and analysis, whether they are right or wrong I don’t know, is that people take a barbell approach where they have a lot of equities and a lot of cash and probably moving a lot into cash. If you look at those two asset classes and no differentiation in between, you might think ok, cash is a conservative asset class that is giving me 2.50-2.75% whatever you can get on cash. If I’m over-exposed in cash how do I look at the granularity of that and what do I look for in terms of conservative assets? As an example if you looked at the capital structure and you looked at bank sub-debt, such as a bond. You have the top of the capital structure for ease,would be term deposits, then senior paper issued by a bank, and then sub-debt the next level down and then hybrids which everyone would be familiar with, then there’s equity. Senior paper trades at 1.25 over the cash rate, sub-debt is about 2.50 (over) and term deposits are about 80 basis points (over). There will be some differences within that but let’s say they are the rough numbers we are looking at. The way I think of it is the senior paper is giving you a 50% better return. And the sub-debt is four times (approx.) the return you are getting. I’m not asking everyone, and clients aren’t putting all their money into sub-debt. They are saying I’m over-exposed so if I have $100 and I really only need $80. I might look at how I spend that $20 to get a better performance out of my cash bucket for conservative assets. Everyone needs to go and get their advice but it’s about the granularity of your portfolio and trying to, without overly trading, have a portfolio construction that meets your needs, but gets the best outcomes easily available without taking too much risk. I think the repricing of credit gives us opportunities at the moment.

PH: It’s been a roller coaster ride to start 2016 and it doesn’t look like volatility is going away. What is the lunar year of the Monkey could end up being the calendar year of volatility, and it’s always worth having a chat to somebody about getting some advice based on your own circumstances and situation. Mark Todd, thank you very much for your time.

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