FED UP - NAB Business Markets Podcast – 17 December 2015

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

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

PH: Hello and welcome to another NAB Business Markets podcast, I am Peter Hartley and I am joined today with Mark Todd, Director of our Capital Finance (team) here at NAB and also host of the Sky Business TV show 'Your Money, Your call'. Mark thank you for joining us.

MT: Pleasure.

PH: Mark overnight there been some interesting progress in terms of the interest rate markets around the world with the U.S Federal Reserve coming out with their announcement. What we've seen is the Federal Funds Rate has been lifted by 25 basis points or a quarter of one per cent and this is the first rate rise in almost ten years and probably coming on back of 7 years of.0 per cent interest rate policy in America. What's your thoughts, is this exactly as you anticipated, what should we be reading in to this?

MT: Peter, I love the way you described it as 'Fed Up', I think the Fed managed the expectations really well. It was surprising to me to see the volume of money going into the cash market. $13.5 Billion went in last week into the cash market. Which was, when you consider how assets have been sold off it that didn't seem to be an intelligent strategy around getting liquidity for liquidity sake and moving into cash. But the Fed set the market up, delivered on expectations, everyone thought it would happen. I think the main game is actually the press conference, the way I looked at it Fed Chair Yellen did an outstanding job of taking all questions and answering them in a way that said to a lot people looking at the press conference, that she across the array of issues and she has some views around how to respond to those issues and it meant that the market had greater comfort on the impact of what 'gradual' means as an investor and the perspective on her view on the U.S economy.

PH: So that takes us probably to the 'dot points' or the forward guidance that came with the statement . The Fed's predicting over the next 12 months we could get up to interest rates in America of 1.375% (just as a nice round number). Is this what we should expect? 5 rate rises in the next 12 months or do you have a different view on that?

MT: It would be very hard to be predictive on where rates ultimately end. You should be mindful of the fact that past performance themes would suggest that the Fed has consistently expected rates higher than what they actually turned out to be. It's not as if that that's the goal they want to have, it's just their expectation on the evolution of their economy. Now within the context of that they have said that they'll be gradual, they will respond to genuine data points, what inflation really is and what inflation should be, and how the economy's performance. It doesn't hard to get to 1.375%. Do I think it will get there? Look I would not be surprised if it didn't, only because the rest of the world, acts an anchor to those rates. Europe has just started to go lower yet again and they mentioned in the inflation story part (of the announcement) of the deflation impact of the U.S currency. The US currency, meaning if you have cheaper goods in Europe, you can buy those goods and bring them back into the US, and the goods obviously are cheaper, but your competitor has to go lower. So the US competition has to go lower to compete with the prices you are bringing in. Therefore inflation stays low. Hard to get rates up. I don't see that trend changing any time soon.

PH: And that's exactly what you said a few weeks ago when you mentioned the US Fed doesn't want a super strong American dollar because it will hurt the economy if it goes up too quickly. Is that still your view?

MT: That's right. And that's the view they (The Fed) expressed in the press conference and that's something that's in the back of their mind. We did say that you don't fight the Fed, but the Fed hasn't been fighting. The Fed today entered into the battle and did a really good job and the goal of the Fed was to cause a rally in the long end (of the interest rate curve), which has happened, to give confidence that rates will stay low for a very long time. The emphasis is on the term 'gradual'. The reality that inflation is a challenge but not a concern. So we will respond to the challenge if we need to at some point in time. Everything is projecting forward. It's all about… it just seems that the Fed President was really on top of her game and managed to calm markets and that's what Feds like to do. Central banks just want calm markets.

PH: I loved the quote last time (we spoke) it was (the Fed are) the firemen to volatility.

MT: Yeah, the firemen to the heat of volatility.

PH: In terms of Australian interest rates then. Let's move to the RBA. Let's move to February 2016. What we've been looking at, the swap markets in Australia now, in terms of the 3 year swaps are roughly 30 (basis) points higher than where they were just two months ago. Is that a market over-reaction? Is that something that we could see continue to expect to see grow?

MT: It would be hard to see. I think higher interest rates will be challenging. I don't think that is what will happen. I do think that when you look at when credit funds, like Third Avenue in the US, which was a US$796m fund, has to close up because of its redemptions. That was structurally wrong. It was an open ended fund, so you buy units in a unit trust and they brought really esoteric assets, esoteric credit, and they were offering liquidity which is not feasible. So the structure was wrong. What I think might be happening in places like the high yield credit market, and that will then play in to other markets, is the price for credit. The price I charge you Peter to lend you money. If interest rates go lower, because the Fed is staying low. If interest rates move lower on the basis of someone looking for an asset, they might actually say that the price I lend to Peter might go higher. The spread might go higher because I don't want to have a Third Avenue experience. I feel that that will probably be the emphasis for 2016. Not just the chase for yield. The chase for the appropriate yield.

PH: Especially given capital controls and regulatory costs and watching customer margins right?

MT: Absolutely, you want more conservative banking sector so that the consequences of that is that they take a conservative approach to lending as well as borrowing.

PH: How about the Aussie dollar? NAB is still forecasting 0.68 cent Aussie/US over the next 3 months and maybe 0.68-69 over the next 6 month timeframe. We're holding up around the 72s at the moment. What do you see now that we've had the Fed announcement out of the road?

MT: I think the 2016 theme… If you think about it this way, 2015 was all about the Fed, so what does 2016 become? It becomes more local. It's about how the RBA responds. Is the interest rate setting in the US going to mean that more money will go into the US and less money comes into Australia? That has been the standard operating procedure. That's not necessarily the goal of the Fed and it's important for people to think about it (this way). If you are controlling monetary policy, what's your goal? The goal here locally will be to keep the pressure (the downward pressure) on the Aussie (dollar) because of the stimulatory effect it has had in the economy. The benefit it has derived. I'm not saying it won't get into the 68s, I am saying it might need a bit of work to get it into the 68s and that will be a RBA piece of work. I don't know that, our economy is quite strong, and I don't know that it's obvious that you want to straight away short Aussie, you just need to wait and see how the RBA responds and I think that response takes through first quarter 2016 and it'll be hard, but it's something the RBA is very coconscious of they have been doing a great job so I think they will continue on.

PH: Mark, I completely agree with the fact that the whole world has been focused on what the Fed is going to do and now that we have hit the Fed announcement, we need to be having a look perhaps at what is coming up next and also what we might have missed while we were just waiting for the Fed, and what we should've been looking at as well. You touched on the Junk bond market and the fact that there are some redemptions and some funds that are closing down. What other risks do you see that we should be watching in terms of the data points that could trigger still a bit more volatility in the market?

MT: So, when I think about probably one of the more important things is to think about that concept of liquidity versus risk and making a differentiation between both aspects. You might be… I'll use the annuity market as an example. If you take out an annuity you don't have much liquidity. Liquidity is based on what you have done. It's your cashflows. So there isn't a great deal of risk because of the regulatory environment that the annuities are offered under. I think it's important to think about liquidity to what end? Why do you need that liquidity? What are you looking to do? (As opposed to understanding your underlying assets). So I think for 2016 it's more about credit analysis or underlying analysis. Not that many people picked the commodity rout. Not that many people understood that was going on. That's a fair assumption because you've seen the volatility in BHP and some of the volume that's taking place, would say that they didn't pick it. So I think its important to think about portfolio construction, around what do I need to have in liquids. The reason is, its livelihood – I'm using this money to live off. Keep that in something that is incredibly liquid. Then the next part is, what's the story of risk and can I take volatility. So if I like the underlying risk and the volatility means the markets move around, I'm agnostic to the market movements because I've picked up in terms of the risk. And a lot of these assets are producing some pretty high spreads. You think of if we have equities with high dividend yields at the moment, there is talk about them being challenged but again you have to think about what does the challenge mean? What will the yield ultimately be? Hybrids pay 500 over, you've got sub-debt at 275-300. You're getting some pretty high senior paper. I think there are options around to build up portfolios that will be possibly less volatile, but certainly you are potentially being compensated for the risk.

PH: And what's your thoughts on oil now that we are back around the US$35-37 a barrel, is this something that we should be worried about?

MT: Not if you're driving. I think it's a story of supply. And the people listening to this, you should not lose sight of the irony when OPEC was speaking through 2015 saying that they will manage all the oil producers and come to a conclusion on where oil should be issued. So it's Venezuela, it's the US, it's Russia, it's Saudi Arabia and Middle Eastern countries. The idea of that UN of oil producers coming to a conclusion is hard for me to imagine. So it's a story of supply. If the price moves up, you will see more and more oil. I just don't see it being a capacity of the price to move up, it will just be onward supply pressure. That would suggest that the benefits of that are different. In Europe they see that as somewhat of a negative, as a sign the economy is weak. In the US they say it's an opportunity to drive further. They literally drive more miles. They don't necessarily bank the money, they use it. It's a cultural change.

PH: Is that an alternative to flying or are they just enjoying lower petrol prices?

MT: I think it's a bit hard to walk anywhere in the (United) States. There's not a lot of pathways. And I lived there for 3 years. It's one of those challenges.

PH: So then, before we wrap up, what's your view on a potential "Black Swan" event that could come out of the background over the course of the next few months into 2016?

MT: I suppose if you define it, it loses its Black Swan status. But I will still have a go at it. I do think the when you look at the election cycle in the US, I am telling everyone it just needs to be priced (in) and I am of the view that the Fed doesn't want the currency that much higher. The US is going to change government. There is going to be a process that is going to happen, and that will happen in November (2016) but that process starts on the 1st of February (2016) with the Republican voting in Iowa. I just think you need to watch that, to say is that consistent with what the global political world would like to see. The two people that will ultimately be combatants for the Presidential primaries, you want to think about what their external policies will be to the rest of the world. How they treat emerging markets. How they treat some of the challenges that the global economies have. At the moment, that could be the Black Swan.

PH: Well Mark, that's probably just about it for the update following the Fed announcement. I just want to thank you again for your time, and thank all our customers who have joined us for listening today and wish you all a Merry Christmas and good luck into 2016.

MT: My pleasure. We'll do more work in the New Year.