SALT INSIGHT

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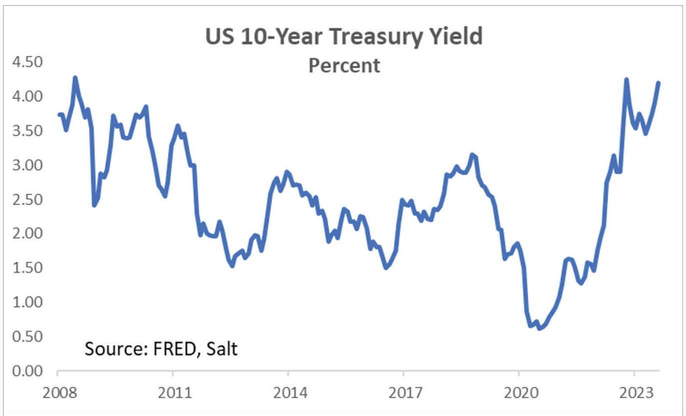
What's going on in the US Treasury market?

Yields on US 10-year Treasuries have risen sharply in recent days. This runs counter to the conventional wisdom that as monetary policy interest rates peak, yields at the longer end of the yield curve rally (i.e. the curve inverts or becomes more inverted) as growth slows and inflation (hopefully) moves back to target.

Yet here we are with US 10-year Treasury yields back up to the 4.20%+ level and threatening to break through the peak for this cycle of 4.25% seen in October last year as the Fed was tightening aggressively. That October peak was itself the highest level seen since before the Global Financial Crisis (GFC). In fact, you have to go back to the 13th of June 2008 to find a yield higher than 4.25%.



Of course, the US yield curve is currently inverted with the conventional measure, the spread between 10-year and 2-year Treasury yields currently around 70 basis points. With the longer end of the curve currently under pressure, any flattening of the curve from here would likely be driven by even higher long-term yields.

This move higher at the longer end of the curve is not being driven by changing expectations of monetary policy. That has its influence in the short end of the yield curve. The move higher at the longer end of the curve is being driven by a number of factors, some of which are more important rather than others, but all contribute to a picture of higher yields going forward. Many of these issues have already been addressed in some detail in our recent Structural Themes Insights paper.

In our view, the trend higher in yields can be attributed to the following factors:

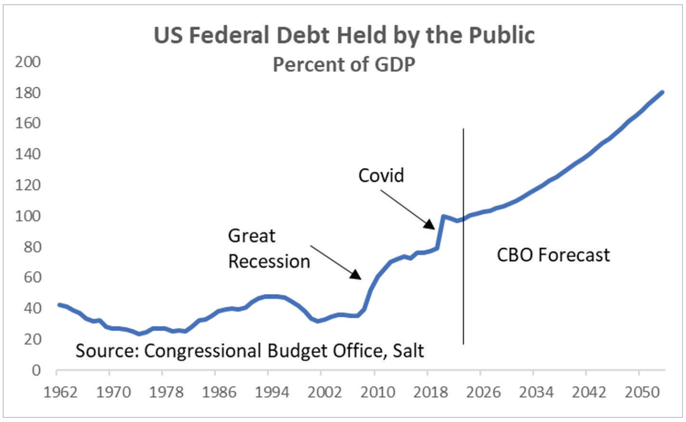
1. The US economy is expected to skirt recession and enjoy a soft landing. While that's good news for the economy, it does mean that it will take longer to get inflation back to target meaning interest rates can be expected to stay higher for longer.

2. Likely persistent structural trends means that inflation is expected to be higher in the period ahead. We believe that after spending most of the period since the GFC in the bottom half of target bands, inflation is more likely to spend most of the time in the top half of inflation target bands. That means that when interest rates are able to be cut, they are unlikely to go back to where they came from. Neutral, mid-cycle interest rates are

higher than they were before the pandemic.

3. US bond market supply is ramping up. As the US fiscal situation deteriorates, more bonds will be issued. This is at the same time that the Federal Reserve is undertaking QT and selling bonds into the market. More supply means lower price/higher yield.

4. We are not as dismissive as the consensus that the recent downgrade of US sovereign debt was unwarranted. From our perspective, fiscal policy is on an unsustainable path in the United States (and many other developed countries), and politicians seem either unable (the generous depiction) or unwilling (the probably more correct depiction) to do anything about it. The Fitch downgrade of US debt held significance due to its potential impact on borrowing costs, investor confidence, and global financial stability. This credit rating downgrade signalled concerns about the US government's fiscal trajectory, influencing market perceptions and potentially affecting interest rates and economic growth.



5. Finally, normally the US bond market sets the tone of global bond markets. But traders and investors are also keeping a wary eye on the Bank of Japan following the second "tweak" to its Yield Curve Control policy. While the BoJ was at pains to paint this as supporting the functioning of the market, it is coming at a time when inflation and importantly wage inflation are at long term highs in Japan, suggesting an element of covert monetary policy tightening.

Implications for Investors

These developments in bond yields have major consequences for portfolio management. Firstly, in the bigger picture, a Sovereign downgrade of the credit rating for US Treasury bonds is meaningful. The yield on such securities is conventionally treated by markets as a "risk-free" rate of return, and other, risky assets which might potentially one day either default or be liquidated are expected to return to investors a risk premium as compensation.

If there is any element of doubt as to whether US bonds are truly risk-free, other assets may not need to promise to deliver such wide expected returns in excess of Treasury's to remain worthwhile investments. This shouldn't be overstated, as the US situation is the result of conscious choices by the US Administration that may be revised, and the Federal Reserve ultimately has the power to prevent default or deferral of US bond coupon payments, and to buy up distressed securities. However, investment strategists must reckon with no longer living in a world where a genuinely riskless security can be used in their calculations.

Of more immediate interest, though, is the set of investment strategy implications summarised below:

1. Conventional wisdom would have argued to add Sovereign Bonds to portfolios at the start of 2023. This would have been premature. Government bonds have underperformed Investment Grade corporate bonds by more than 5% for the last 12 months, which is a considerable performance gap in the bond world. So, our view has been that portfolio Fixed Income allocations may be incrementally lifted this year, but very selectively. We are guided by our Structural Themes approach and are employing our Sustainable Global Fixed Interest fund to build additional bond positions. A specialised fund can offer differentiation due to the green, sustainability-linked bond and non-sovereign components which are not as vulnerable to the forces described above.

2. Many Sovereign debt issuers have painted themselves into a fiscal corner. It is difficult to see how this will be resolved, without some very difficult and politically unpopular choices.

3. Long-duration interest rate sensitive equity securities have gotten ahead of themselves in their valuations, but some have new and compelling narratives driving them upward, particularly in IT where Artificial Intelligence is becoming a key theme. US and European developers and associated industries like Health Care and Cellular infrastructure still retain a positive profits outlook, but careful active management is needed to sort the value from the hype.

4. Traditionally defensive equity markets like NZ may not behave as defensively as in the past, due to the interest rate sensitivity of earnings in the key Utilities and Telecoms sectors. However, much of this disadvantage has played out already in 2023 as NZX has underperformed. 2024 could potentially see much better conditions for NZ equities, but risks to the market then are likely to come from abroad, regardless of domestic factors. Active management will be critical.

5. A reputation for "safe haven" markets has to be approached with an eye to the future, rather than to past performance characteristics. For example, the

Swiss equity market has been a poor performer over the last year, as a very high currency has hurt corporate earnings. That is in spite of the exemplary Swiss fiscal situation (and low corporate tax rates.) Japan, by contrast, has been the best major global equity market in 2023, due in large part to a very weak Yen boosting exports. Again, active selection is key to performance.

6. With US yields remaining higher for longer, currency adjustments are likely to see an extension to US dollar strength, making a lower hedging ratio for international shares still valid, as least for the latter part of this year. The weakening trend currently seen in the NZ dollar is a reflection of poor prospective returns from currency-hedged bonds and key "carry trades" around the world will continue to unwind. The situation in Japan is the key influence, given the scale of Japanese foreign securities holdings.

7. Debt-financed (leveraged) investment options are still inadvisable, as the cost of financing will remain elevated for some time ahead. Downward revaluation is progressing for Direct and Private Equity asset pools, and this has further to run. Listed assets, being much more liquid, have largely already priced in the burden of higher debt servicing costs.

8. Instead of relying exclusively on government and quasi-government bonds for portfolio income yield and medium-term diversification benefits, we prefer to add in Real Asset classes. These select long-duration securities within the Infrastructure and Real Estate sectors have a stability of dividend yield and often, inflation-protection features. Although they may be conducting their business in regulated markets, they do not tend to rely on tax revenues to earn their operating profits. There is also rising global interest in financing good-quality Real Assets, as the world transitions towards renewables (benefiting Infrastructure) and the population aspires to enjoy a better built environment (benefiting Real Estate).