ARDEA Investment Management

Ardea Australian Inflation Linked Bond Fund

ARSN 622 519 117 APIR Code HOW0062AU

Quarterly Performance Report December 2020

Performance (% p.a.)[1]	1 month	3 months	6 months	1 year	3 years	5 years	Since Inception[2]
Portfolio (net)	1.24	2.51	6.50	6.55	6.50	4.86	6.74
Bloomberg AusBond Inflation Government 0+ years Index	1.20	1.67	5.34	6.96	6.30	4.75	6.25
Active return	**0.04**	**0.85**	**1.17**	**-0.41**	**0.20**	**0.11**	**0.49**

[1] Performance figures are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures. Past performance is not a reliable indicator of future performance.
[2] The Fund's inception date is 18/03/2010.
Source: Fidante Partners Limited, 31 December 2020.

Fund Commentary

The portfolio outperformed over the December quarter, reflecting gains from breakeven inflation strategies, yield curve arbitrage strategies, semis, and bond-swap strategies.

Breakeven inflation strategies contributed positively over the quarter, assisted by the portfolio's overweight positioning towards the long end of the inflation curve. Long end inflation expectations continued to benefit from the global uplift in inflation expectations and the reflation trade more broadly, although some of this is being reflected to a greater degree in short-end inflation expectations. This reflects the market's response to the US Federal Reserve's (the Fed) switch to average inflation targeting, which allows for a greater overshoot in short-term inflation, and - at least in theory - greater stability in long-term inflation expectations. This reflects the rationale that the Fed will allow short-term overshooting of inflation, but not "permanent" overshooting such that long-term inflation expectations can remain stable.

Yield curve arbitrage strategies contributed positively over the quarter as a whole, but gave back a little of this performance towards the end of the quarter. The portfolio benefited earlier in the quarter from being underweight the long end, which underperformed on vaccine optimism and the reflation trade more broadly. Towards the end of the quarter however the portfolio's overweight to the intermediate sector of the yield curve weighed on performance a little, as markets began to further pressure bond yields higher. With cash rates remaining firmly anchored, the upward pressure on yields was more concentrated on bonds of intermediate tenors than would be the case if cash rates were not at zero.

Strong gains from semis earlier in the quarter became more modest towards the end of the quarter. Semis continue to attract good demand from domestic financial institutions for regulatory capital purposes, and given the ongoing increase in issuance, this has enabled banks to satisfy a larger portion of these requirements by holding government bonds directly. This is instead of relying on the Reserve Bank of Australia's (RBA) Committed Liquidity Facility, with the Australian Prudential Regulation Authority (APRA) announcing early in the new year a further reduction in the size of this facility. APRA made direct reference to the unforeseen increase in the availability of high-quality liquid assets (HQLA), as a result of the rise in semi issuance. The portfolio has holdings in NSW, Vic, and Tas.

Market Commentary

Notable events for the quarter are summarised below and more detailed discussions of topical market themes are available here - **Ardea's market insights**.

What happened?

In December, markets broadly continued down the positive risk and reflation path. Equities posted healthy monthly gains yet again (S&P 500 +3.7%, MSCI world +4.1%), sovereign bonds were mixed (US 10y yield +7bp, Bloomberg global treasuries index return +1.5%), credit spreads sustained tight ranges and the USD continued to fall (DXY -2.1%). These moves cap off an extraordinary year for markets, where a global pandemic drove one of the largest downturns in modern history, yet many asset prices rebounded sharply. Sovereign bonds also finished 2020 with solid gains, despite the weakness in some markets, such as US Treasuries, over the last month.

Chart 1: S&P 500 vs US 10y yield

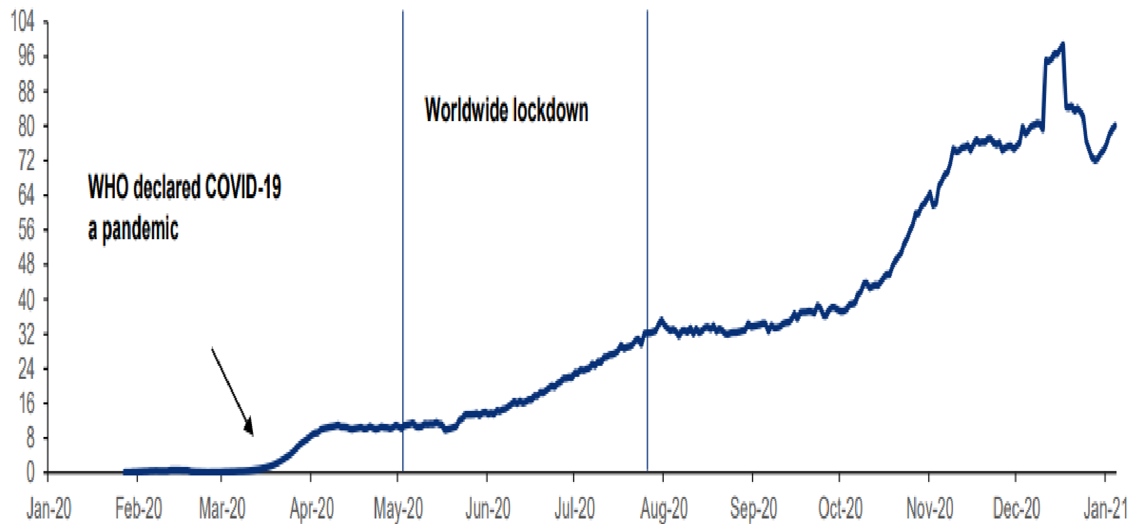
Source: Ardea, Bloomberg

Vaccine and fiscal policy optimism eclipses virus infection concerns

The dominant market narrative in December focused on the roll-out of COVID vaccines, which trials in November showed as highly effective. The massive task of delivering vaccinations got underway in the US, UK and Europe. There is a very long way to go before major economies see anything like herd immunity, but the fact the program has started before the end of 2020 supports the optimistic 2021 outlook underpinning current asset valuations.

So bright is this light at the end of the COVID tunnel that markets are willing to overlook rapidly rising case numbers in the northern hemisphere. Government mandated lockdowns and social distancing measures increased over the month in many countries, denting near term economic recovery prospects. Investor nerves were also tested by reports of new variants of COVID in the UK and South Africa.

Chart 2: COVID cases per million (7d MA)



Source: Deutsche Bank Exit Strategy Policy Tracker, 5-Jan-21

Beyond vaccines, policymakers continue to support market confidence. After much debate in Congress and uncertainty, late in December, US lawmakers agreed on a $900bn stimulus package in time to avert a government shutdown. While markets had started to price this outcome in ahead of time, the confirmation of the package supported risk sentiment. Investors also began to contemplate a January Georgia senate race which had the potential to hand senate control to the Democrats – the market implication is widely thought to be a much larger fiscal spending package.

Central banks: European Central Bank increases quantitative easing, other central banks maintain status quo

Beyond the fiscal and vaccine tailwinds, huge central bank liquidity flows continue to buoy asset prices. At their December meeting, the ECB announced plans for a further €500bn of new bond purchases and an extension of the QE program until March 2022. The ECB's aggregate stimulus for 2020 has now reached over €3tn. As outlined in a December Ardea research note on negative rates, there are broader implications of the latest round of ECB policy easing:

- **European bonds are resilient.** Euro sovereign bond markets have sustained low yields or seen new record low yield levels over the last two months, even in the face of very positive vaccine news.
- **QE viewed as critical to the recovery**. The ECB expects to continue buying bonds through 2021 even as growth is anticipated to rebound sharply with vaccinations rolled out across populations. Elevated unemployment and long held deflation fears remain front of mind for the central bank.
- **ECB bond demand set to exceed supply**. Market participants expect ECB QE to exceed the net new supply of bonds being issued in 2021 – an extraordinary outlook considering the record volumes of fiscal stimulus being thrown at economies.
- **More negative yielding peripheral debt.** Spanish and Portuguese 10y bond yields traded at negative yields for the first time in December – a far cry from the over 7% and 14% respective peaks seen through the sovereign debt crisis earlier this decade.

The total global pile of negative yielding debt reached a new record high of US$18tn in December.

Chart 3: The market value of the global pool of negative yielding debt

Source: Ardea, Bloomberg

The US Federal Reserve (The Fed), somewhat surprisingly for many market participants, kept policy settings on-hold. There was widespread speculation the Fed would increase the duration of their portfolio to guard against the risk of a steeper curve amid market hopes for a recovery. Instead, the Federal Open Market Committee (FOMC) tweaked their qualitative guidance, committing to the current pace of asset purchases "until substantial further progress has been made toward the Committee's maximum employment and price stability goals".

The Reserve Bank of Australia (RBA) made no changes to policy in December after committing to substantially larger QE purchases in November. The implications of RBA liquidity injections continue to be felt by the market. In December, a small allocation in 3 month T-note tender cleared at a negative yield – the first ever sale of negative yielding nominal debt. In a recent note we showed this outcome reflected both the high levels of excess liquidity from the RBA and cross-currency basis levels.

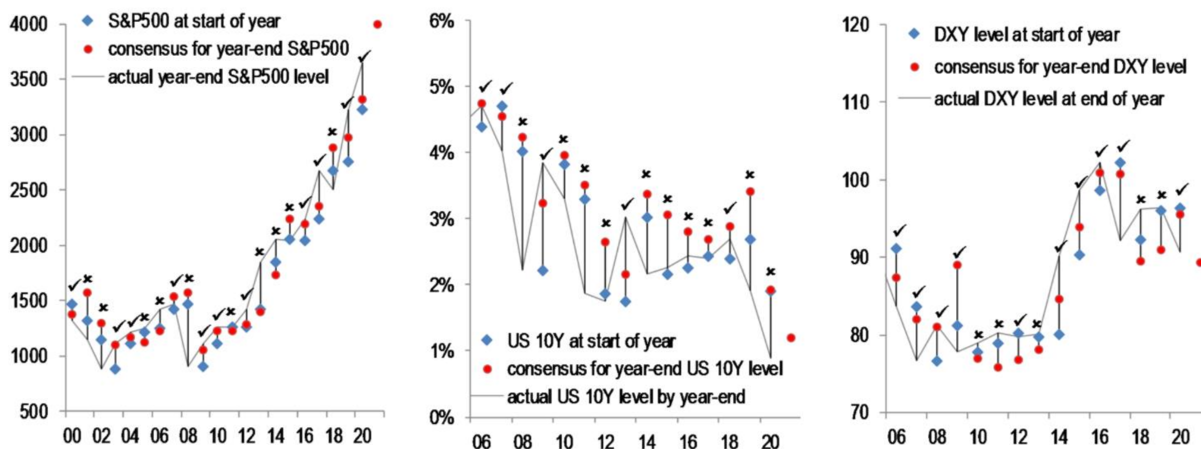
Why is it relevant?

Risks to the positive 2021 consensus

The end of 2020, as with any other year, brings with it predictions and forecasts for the year ahead in markets. After such a tumultuous year, one might think the year ahead views would see a much greater than usual dispersion of views on asset returns and the global economy. Yet, generally investors and analysts seem to have a broadly similar pro-growth/pro-risk narrative that extrapolates the last few months price action. Economies are expected to rebound strongly, stocks to post solid gains, while only a modest sell-off in developed market bonds ensues. Vaccines and stimulus from governments and central banks are expected to support asset prices.

Of course, it's worth having some healthy scepticism about consensus views. As the old market saying goes, "what is obvious is obviously wrong" – often referring to the risk of crowded investor positioning which can lead one to experience trading losses despite having the right macro or event call. Or perhaps some sort of new market driver or event risk emerging. JP Morgan strategists in December showed consensus forecasts have historically not been uniformly bad at predicting the direction of markets, but their track record varies considerably by asset. They showed that *"consensus forecasts have correctly called the direction of US Treasury yields only 40% of the time, the S&P500 only 50% of the time, but the DXY (dollar) Index about 67% of the time"*. The historically less volatile bond market has been the harder call to get right!

Chart 4: Consensus vs actual outcomes for the S&P 500, the US 10y yield and DXY



Source: JP Morgan, 17-Dec-20

As for what could shake the optimistic 2021 market outlook, we suggest a few key risks:

- Virus mutates or vaccines don't work;
- Fiscal support is scaled back;
- Geopolitical volatility, such as trade wars, return to pre-covid ascendency;
- Central banks foreshadow tighter policies.

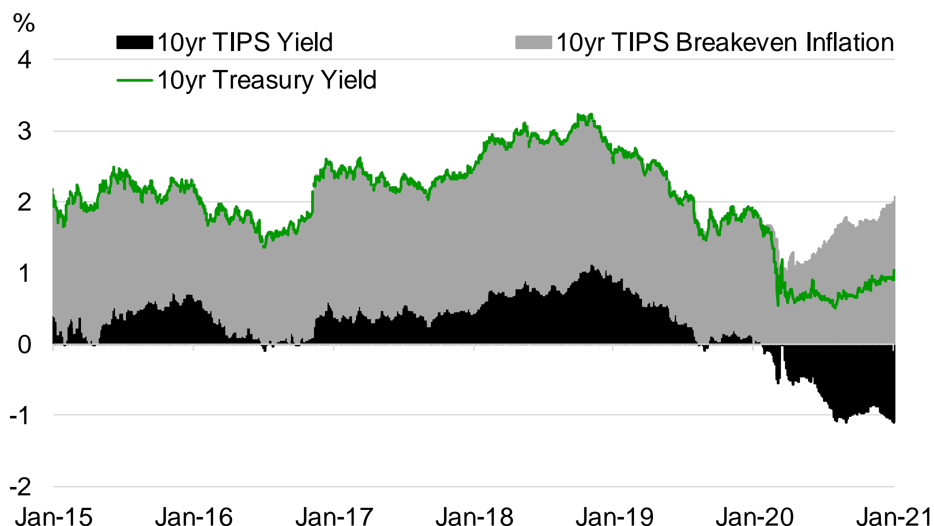
Bond yields drifting higher and rising inflation expectations – a gathering storm?

Nominal bonds are starting to come under pressure, but at the time of writing in early January these moves remain modest by historical standards. The US 10y yield has drifted from 0.87% at the end of November to finally push over 1.0% in early January for the first time since March. The outlook for more fiscal policy and a vaccine-driven rebound in growth is supporting a repricing of long term rates.

Most investors and strategists see long term yields settling around 1.20-1.50% for US 10yrs in 2021 and a similar sized sell-off is envisaged in other developed markets (ECB actions make for a less bearish outlook in Europe, as discussed). These views are generally in line with or slightly above the forward curve. The reason for the conservatism is largely because of confidence that rate hikes are a very distant prospect, while Fed and central bank QE purchases should ultimately cap how much higher long term yields can go. Past experience suggests the Fed and other central banks will seek to lean against a destabilising sell-off, but the strike on this so-called Fed put is often much higher in yield than markets initially assume.

What could really damage confidence in this benign drift higher in rates is the re-emergence of inflationary pressure, a risk that is not being discounted heavily by economists but which the market is increasingly wary of. As we have discussed in recent market updates, the path for long term market implied inflation expectations has more closely tracked the rally in risk assets. As nominal rates have drifted slightly higher, real yields plummeted to near all-time lows at the end of December, propelling breakeven inflation rates higher (Chart 5). The entire US inflation curve is now above 2% and the 10yr breakeven level is at the highest level since 2018.

Chart 5: Decomposition of US 10y yield



Source: Ardea, Bloomberg

The inflation repricing speaks to the risk that massive monetary and particularly fiscal stimulus packages will counterbalance structural disinflationary forces. Actual inflation data remains very benign, which demonstrates how allocations to inflation-linked bonds only require a positive shift in the balance of risks to outperform significantly. Even at two year highs, market expectations for inflation of a bit over 2% are not yet at levels that materially threaten multi-asset portfolios. But if this rising "inflation risk premia" continues at its recent pace, then it could soon start to shake entrenched low levels of interest rate volatility and assumptions about the durability of central bank support for all asset prices.

In our December market insights note, we examine the risk of inflation and the implications for broader markets in much greater detail.

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