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Robert Mead
managing
director and
head of portfolio
management,
PIMCO Australia

The New Neutral for bond investors

Five years after the global financial crisis, many economies are still feeling the after effects. Many countries are contending with high levels of debt, reregulation and challenging demographics. And as a result, economic growth has suffered.

For many investors, however, the environment has been much more beneficial. Central banks have provided a tailwind in the form of stimulatory monetary policy. Government bond yields have been historically low while equities have outperformed. Low interest rates have also sent many investors flocking to Australia in the search for yield, sending the Australian dollar higher.

How long can investors expect this environment to last? This is one of the many questions we ask ourselves every year at PIMCO's Secular Forum – an opportunity for us to stop and think about where the markets will be, not tomorrow or six months from now, but three to five years down the line.

The New Neutral

At this year's forum our investment professionals from around the world came together to hear the views of several outside speakers – well-known economists and policy and industry leaders – and then discussed and formulated our longer-term outlook. We concluded that the global economy and markets have entered a phase we call The New Neutral – an era in which the global debt overhang will constrain central bankers' monetary policy options while global economies converge to modest trend growth rates with low inflation.

As the US Federal Reserve and other central banks in developed economies move toward policy normalisation, we expect them to target real policy rates closer to zero rather than the 1%–2% that may have been expected in previous cycles. In Australia, we do not expect the RBA to hike rates for an extended period, which has significant implications for investors.

With interest rates likely to remain lower for longer, bonds should provide a stable source of returns in a portfolio in the coming years. Overall, we believe that bond (as well as equity) market returns will be modest over the next three to five years. However, we believe risks and volatility will be lower as well. Yields are unlikely to increase much above current forward rates, in our view, while equities and other risk assets remain relatively range-bound.

A portfolio anchor

While our forecast for returns is modest, we think it is important for investors to remember that the bond market still represents a compelling

opportunity and remains an important part of a portfolio's asset allocation. We believe the next three to five years will be a good time for investors to anchor their portfolios with bonds.

So why anchor your portfolio with bonds? Because they provide important benefits:

- **Income** – consistent, compounding interest from bonds can help build a sustainable income stream to meet expenses; as rates gradually rise, so can income over time. Bonds also offer growth potential from price appreciation.
- **Capital preservation** – bond market dips have tended to be significantly milder than those for stocks. Protecting principal is a key objective for those with a lower risk tolerance or less time to recover from a sharp market shock.
- **Steadier returns** – bond prices can fluctuate, of course, but because the bulk of their returns are derived from income, they tend to deliver a smoother ride than assets such as stocks.
- **Diversification** – investors can potentially increase returns and reduce risk by broadening their portfolios across asset classes. Certain asset classes perform better under different market conditions, and there's no way of knowing when conditions will change.

Be selective

Passive fixed income investing is not enough, however. We believe investors should favour active managers who employ bottom-up research to identify opportunities in countries, sectors and companies that are growing faster than the economy.

This is especially important in an environment of more modest market returns. Active managers have many tools at their disposal to generate higher returns, and they use them. Passive managers essentially lock in 'beta-minus' net-of-fee performance. Of course, active managers face their own risks, and even the best of them can underperform at times. But we believe passive management presents more risks – and in an environment of historically lower returns, investors need all the help they can get to meet their investment needs.

Investors can maximise flexibility to play both offense and defence in The New Neutral. They can pick which country, currency or sector, or, more specifically for fixed income investors, what part of the yield curve to target. These decisions shouldn't be made in a vacuum; they are highly dependent on relative growth rates, inflation levels, policy actions and valuations.

At this year's PIMCO Secular Forum, the company's global executives set themselves the challenge of taking a three to five year view and anticipate where the market would be against what investors would be seeking.

They conclude that the bond market presents a compelling opportunity in the medium term; global debt will check central monetary options and modest growth rates will likely be balanced by low inflation. They refer to this coming era as 'The New Neutral'.

We invited Robert Mead, managing director and head of portfolio management at PIMCO Australia, to describe their thinking and the opportunities presented in this timeframe to give our readers the benefit of their insights.

Michelle Baltazar
Michelle Baltazar
Publisher

Company analysis will also be key in The New Neutral environment of slower yet differentiated growth. Credit and underwriting cycles, company/ issuer fundamentals, relative value, currency and capital structure are all factors that an active manager should evaluate closely and use to make their investment decisions.

And while we expect volatility to be lower overall, the potential remains for volatility spikes in The New Neutral. Active managers can guard against these spikes by using direct or indirect hedges. They can also use these spikes to their advantage by adjusting over- and under-weights accordingly. Only active managers are equipped to capture this potential for value.

The New Neutral for Australia

What does this mean for fixed income investors in Australia? The big takeaway is that we believe current conditions in Australia warrant continued stimulative monetary policy by the RBA.

Global investors on a hunt for yield have headed to the Australian market, pushing the Australian dollar towards the mid 90s against the U.S. dollar. Accompanied by tightening fiscal policy and tapering mining investment, we believe the current 2.5% cash rate is appropriate and likely to stay on hold for an extended period. Interest rates could rise eventually if stimulative policies gain traction in the Australian economy. But we believe even an increase to 3.5% would be enough to start to restrict Australian economic growth.

Overall, we believe the income, capital preservation, steadier returns and portfolio diversification of bonds will continue to offer value to both Australian and global investors in The New Neutral. **FS**

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