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Taper time for mining sector

While attention is fixed on the US Federal Reserve’s plans regarding quantitative easing, it’s a tapering of another kind that investors should really be focused on. Ben Power explains.

Global investors have been fretting about the impact of a possible US Federal Reserve tapering. But a new report from PIMCO warns that Australian investors should be factoring in the fallout from another form of tapering: the tapering of mining investment in Australia.
In a report, *Taper Time – Mining, That Is*, PIMCO’s Adam Bowe and Robert Mead say that a fall in mining investment is already hitting the Australian economy, and the Reserve Bank of Australia (RBA) will be forced to keep official rates low, and potentially even cut them further in the next 12 months, in a bid to boost investment growth outside the mining sector.

The outlook for rates has major implications for advisers and their clients. It suggests that cash and term deposit yields will remain low and even keep falling over the next year.

Many clients are also worried about capital losses on bond portfolios as a result of rising interest rates. But the mining tapering and its effect on rates means that bond prices could actually rise in 2014 as the market realises that rates won’t be hiked.

**ENORMOUS EXPANSION**

Australia has had many mining booms, but none matching the enormous expansion that began in 2003 and triggered massive investment in the resources sector, including coal mines and liquefied natural gas (LNG) plants. From 2003 to 2012, the global mining sector is estimated to have invested $234 billion in new projects and expansions in Australia. Some 46 per cent was financed from offshore. Over the past 12 years, mining investment as a share of GDP has risen sixfold to nearly 7 per cent. But over the past couple of years, while the mining expansion was occurring, the rest of the economy struggled, growing below trend.

The mining boom has three phases: the “price” phase, with record prices; the “investment” phase; and the “production” phase, when output and exports will ramp up. Most economists agree the price phase is over; and there are now signs the investment phase is peaking and turning down.

Bowe and Mead say recent evidence suggests mining investment is tapering: in the six months to June 2013, mining investment detracted 0.5 per cent from overall GDP growth. But no other sectors were driving growth, so the nation’s economy grew just 1.1 per cent in real terms in the first half of 2013. That’s the slowest six months of growth since the financial crisis ended in 2009.

**The good, the bad and the ugly**

In their report, Bowe and Mead say there are three growth options, which they’ve dubbed the good, the bad and the ugly.

Under the “good” growth option, non-mining companies renew business investment, and there is a smooth handover from the mining sector. But Bowe and Mead note this hasn’t happened yet: real growth in non-mining business investment has contracted in the year to June 2013. What’s more, with dividend payout ratios increasing in the past 12 to 18 months, firms seem to prefer paying earnings back to owners rather than reinvesting in their own businesses.

The “bad” growth outcome would see demand continue to slow as the global mining sector tapers, and no new sectors step forward to drive future growth. Bowe and Mead say the first half of 2013 fell into this category, and the RBA responded by cutting the cash rate by 0.50 percentage points.

The worst outcome is the “ugly” growth scenario. That’s where a sector, such as household consumption, is boosted by low rates. It might create a short-term boost to the economy, but the increased leverage on household balance sheets from already elevated levels would create longer-term risks to the outlook.

“The RBA would face a very difficult policy dilemma in this environment, constrained from providing the policy support required in other parts of the economy due to fears of creating imbalances in the household sector,” the authors say. They note that real household consumption actually decelerated in June to its lowest year-over-year pace since the third quarter of 2009.

Retail sales have grown just 1.9 per cent over the 12 months to July – well below the 30-year average of around 6 per cent.

“However, the potential for the household sector to expand its balance sheet is still real, particularly in light of the recent recovery in house prices,” they say. The Australian house price index rose 3.2 per cent in the first half of 2013, the quickest pace since the first half of 2010. The upshot, according to Bowe and Mead, is that until new sectors can expand, the base case is sub-trend growth for Australia.

In this environment, we expect that the RBA will have to keep interest rates low for an extended period, and likely lower them further, supporting bond prices over the cyclical horizon,” they say.
WIND-DOWN
Saul Eslake, chief economist at the Bank of America-Merrill Lynch, says there is some evidence that the wind-down of the investment phase has been worse and quicker in Western Australia than had been expected: the trend unemployment rate is up 1 per cent since June last year, labour force participation rates have dropped, and retail sales growth has slowed from nearly 10 per cent in 2012 to just 1.4 per cent in the year to August. In Queensland, the LNG investment boom is still going strong, Eslake says, but coal investment is winding down.

Heuristic Investment Systems’ Damien Hennessy, a consultant investment strategist to van Eyk, says that mining will continue to detract from growth over the next couple of years, but he believes that a surge in exports on the back of a doubling of production capacity over the past decade will provide a “bit of an offset” to falling mining investment.

But while export volumes rise, prices are likely to soften. “I suspect [commodity] prices will continue to fall a bit as China growth slows in a structural sense over the next few years,” Hennessy says.

Bowe says that policymakers have a relatively blunt instrument in terms of their monetary tools to generate any rebalancing of the economy away from mining. State and federal governments are also in consolidation mode, so fiscal stimulus is constrained.

Refocused for the duration
In light of the recent decline in cash and term deposit (TD) rates, the PIMCO EQT Australian Focus Fund has recently revised its investment strategy to a duration of two years above or below the benchmark.

“This flexibility allows the fund to shorten duration to be more defensive in volatile and rising rate environments and extend duration to take advantage of bond price gains when interest rates fall,” says David Myers, national sales manager, EQT funds distribution. “We wanted to make sure there was enough opportunity for active managers in the Australian bond market to deliver reasonable returns above cash deposits.”

During and after the GFC, nervous investors went overweight cash and term deposits. While some have shifted back into growth assets such as equities, many remain extremely risk-averse and overweight cash and TDs.

But as cash rates continue to fall, many clients are pressuring advisers to explore alternatives that deliver capital stability and a decent income.

Jonathan Tolub, a senior asset consultant at van Eyk, agrees advisers are under pressure from clients to deliver income, but he says there is an element of expectations management required.

“There should be a general understanding that return expectations should be lower now than they were,” he says.

Tolub says that in the new low-return environment, the goal is to lower duration, but at the same time to maintain income for clients without increasing the risk profile.

“Achieving those three investment objectives together is quite difficult to accomplish,” he says. “So at the moment there’s a strong case for multi-managers that [are] aware of those considerations.”

The Australian Focus Fund was developed post-GFC as an alternative to term deposits. Harvey Kalman, head of EQT corporate fiduciary and financial services, says the key objective of the Australian Focus Fund is to preserve capital and provide higher returns than cash investments, notably term deposits, which is precisely what investors are currently looking for. It also offers daily liquidity, which is an advantage for investors who want to be able to draw down their investments when the need arises.

“With term deposit rates continuing to fall, the fund offers investors a viable alternative to term deposits. Because the fund can invest in securities that yield more than cash instruments, it can offer higher returns than term deposits; and because the fund focuses on high-quality bonds and is less interest-rate sensitive than typical bond funds, it can be used to preserve capital, as term deposits are,” Kalman says.

Myers says the fund is currently comfortable being exposed to duration risk, partly for diversification, but also because of the expectation of another cut to official interest rates. But the Australian Focus Fund’s flexibility means it is well positioned for rising rates should the economy improve. “Investors in the marketplace are nervous about rising yields,” he says. “This fund is robust for if and when we see that rising-interest-rate market.”

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Instead, the RBA is seeking to encourage growth in the non-mining sector by cutting rates. “Ideally, policymakers want non-mining sectors to start reinvesting in their business,” he says.

Eslake says he doesn’t expect the RBA to cut rates again this year, although he still does expect another rate cut (and possibly two) next year, as unemployment continues to edge upwards, and the $A remains uncomfortably strong. He agrees the complicating factor is what’s happening in housing. “The RBA doesn’t want to see house prices rising rapidly – it would rather see a strong pick-up in new construction,” he says.

Heuristic’s Hennessy also expects the cash rate to stay low, and thinks there is still a chance of a rate cut next year. Housing construction – not just rising house prices – is required to pick up some of the slack. He says recent strength has made the $A at US95 cents expensive again. “The RBA would be a bit concerned about that if it’s sustained,” he says.

IMPLICATIONS FOR INVESTORS
Bowe says the fact that rates are likely to be lower for longer, and rate hikes are unlikely over the cyclical horizon (12 months), has implications for fixed income.

For a start, cash and term deposit rates will not be rising for some time, and Bowe says there is a risk of these rates declining further from current levels.

At the tactical level, Bowe says PIMCO is seeking to benefit from the market’s premature expectations of rate rises, which have pushed up yields in government and semi-government bonds. He says the market will be disappointed when rates don’t rise, which is creating opportunities to “roll down” the steepest part of the yield curve.

Many advisers’ clients have been wary of bonds in recent times, based on expectations that rates will rise, triggering capital losses on bonds. But the mining tapering and the chance of further rate cuts mean that bonds could actually offer capital gains in the next year or so.

“A well-constructed bond portfolio offers the potential of capital gains as well as regular income from current yield levels,” Bowe says, noting that PIMCO expects the rate hikes currently priced in will not be delivered, causing yields to fall and pushing bond prices higher.
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