ARDEA
Investment
Management

Challenges and opportunities – the year ahead 2016

With the festivities behind us and a new year ahead it is a good time to reflect on what to expect from fixed interest markets. More of the same, or will the end of zero interest rates in the US bring something different?

For an answer we think it's useful to reflect on three unusual features of the global markets which we believe continue to provide good opportunities, but are not without their challenges or potential to negatively impact on performance, as we have seen in the past 12 months.

1) Inflation

It is perhaps not so strange that oil has continued to hit long-time lows. After all oil extraction technology and the imperative to find alternative sources of energy pose a threat to the OPEC oligopoly, so little wonder they are taking measures to hurt the competition.

Much more strange is that the market appears to be extrapolating the deflationary impact of oil years into the future. A moment's thought leads to the conclusion that cheaper oil must surely be reaching its limit in terms of how much money it can save the average consumer.

Low bond rates in general, and the very low multi-year inflation assumptions of inflation-linked bonds in particular, must surely create opportunities for investors.

2) Bond rates

It is not strange at all that interest rate markets are very stable at the moment. Central banks have all set rates low, and are all (yes the Fed too, 1-2% is still low and we are still a long way below that level) going to keep them low for a long time. So there is currently no driver to move bond interest rates much in either direction.

What is strange though is that investors are short sighted enough to sell even long-date interest rate options at extremely low levels of expected volatility.

It seems to us that one of two things is very likely to happen; either, global growth picks up faster than currently anticipated, inflation suddenly becomes a concern and central banks need to raises rates enormously; or else growth falters, central bank's will have tried

everything they can to stimulate their economies, are out of ideas and we are back in crisis. It's not obvious which of these to bank on but we would not want to bet against either.

Owning interest rate options while they are so cheap must be an opportunity for investors.

3) Liquidity

It is not so strange that regulators are getting tough on investment banks. Nobody likes the idea of watching banks make money year after year and then forcing tax payers to bail them out whenever they take too much risk. A notable side-effect of more bank regulation has been a steady decline in bond market liquidity.

What is strange is that the market for *government* bonds has been so badly affected. Governments round the world have big deficits to finance and need to find buyers for their bonds. Surely in this world where quantitative easing has become so widely accepted, governments will find ways to support markets for their own debt so that a reasonable degree of liquidity will be retained.

We think there is a good opportunity to profitably buy and sell government bonds as they go regularly in and out of favour.

Corporate bond markets are likely to remain challenged by a lack of liquidity. A sensible credit strategy means investing for the long term and ensuring the portfolio is appropriately compensated for taking incremental illiquidity risk.

Conclusion

So in conclusion, will there be more of the same or something new for 2016? We think the arrival of something substantially new is inevitable, and will be a dramatic surprise to markets when it arrives. In the meantime, of course it's more of the same uncertainty.

So how do we position the portfolio with all of this in mind? From the perspective of some of Ardea's client portfolios, these ideas are already in the portfolio and have added to investment returns overall, but in recent times they have hurt performance. Despite the recent experience we think these three broad strategies still make sense and when most needed will not only help to protect capital but will also handsomely add to returns in the medium term.