MARKET COMMENTARY

Australian Government Bonds

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Ariel Bezalel started his career at Jupiter and has been a member of the Fixed Income team since 1998 and a fund manager since 2000. He is currently Head of Strategy, Fixed Income and manages the Jupiter Strategic Bond Fund and the Jupiter Dynamic Bond fund (SICAV).

Ariel has a degree in Economics from Middlesex University.

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The listed British investment manager with boutique-like investment approach, located in London and founded in 1985, employs more than 400 employees worldwide (thereof about 35 fund managers). Today Jupiter is one of the UK's most respected asset management groups. „The Jupiter Global Fund SICAV" (a Luxembourg based UCITS structure) provides clients outside the UK access to the diverse investment capabilities through its 29 sub funds which are registered for distribution in several European countries. Jupiter's total AUMs are GBP 42.7 bn as of 31 December 2018.

The Australian housing bubble is close to popping

Tighter lending standards in Australia placed huge pressure on the housing market in 2018 and the country now faces its worst property downturn for 35 years. In this environment, the dynamics behind the housing slump are key to my strong conviction in Australian government bonds.

The last time Australia had a recession, Germany was officially demolishing the Berlin Wall, Margaret Thatcher had just resigned and Donald Trump had yet to declare a single business bankrupt.

Since the "recession we had to have", as then-Treasurer Paul Keating infamously named it in November 1990, Australia has experienced a record period of economic growth, even proving resilient in the face of 2008's global financial crisis. However, we have been monitoring the weakening housing market in Australia for some time, and have concerns that a slow-motion credit crunch is unfolding which could get significantly worse over the next 12 months. In fact, Morgan Stanley recently warned the housing slump could torpedo Australia's run of 27 years without a recession.

The housing market setup in Australia bears striking similarities to that of the US housing market before the global financial crisis. Australia's property market has ballooned over the last 35 years but is now deflating rapidly as banks tighten their once lax lending standards. This followed findings of the Royal Commission in September 2018, appointed by the government to investigate lending practices by the banks, which found that banks were poor in verifying loan applicants' personal expenses.

As a result, credit to the housing market in Australia has dried up dramatically and the country now faces its worst housing downturn for 35 years. National house prices fell 1.3% in December, the largest monthly fall since 1983, bringing the annual decline to 6.1% over 2018.[1]

A further point of concern for us is the poor health of Australia's consumers, who are the most indebted in the developed world, with household debt-to-GDP standing at around 120%. This is somewhat higher than where the US consumer was just prior the global financial crisis. With mortgages making up 56% of all household debt, this is already impacting the Australian economy.

In Q3 2018, Australian GDP growth slowed sharply to 0.3% growth, down from 0.9% the previous quarter. This was half the rate forecast by economists and was largely due to a slowdown in consumer spending. Contracting retail sales in December 2018 reflected the squeeze on consumers. Annual growth for 2018 fell from 3.4% to 2.8% as a result.[2] Building approvals are also collapsing.

We expect the economy to continue to weaken over the next six months, especially as the headwinds of the housing-led credit crunch coincide with slowing growth in China, Australia's largest trading partner, and as potentially disruptive federal elections approach in May this year.

As a result, we are bullish on longer-dated Australian government bonds, which retain their pristine AAA-rating and joined other sought-after safe haven assets like US Treasuries to perform strongly during the intense stock market volatility in Q4 2018. We are also hedging all the Australian dollar exposure in our strategy, as we think the currency will continue to weaken. Interest rates in Australia are around 1.5%, and we think there is potential for them to hit zero given the risks highlighted to the economy.

Indeed, in the first week of December, the Reserve Bank of Australia's deputy governor mentioned rate cuts and even quantitative easing as possible policy options to tackle the weak housing market, both of which would be very positive for Australian government bonds. In February, the RBA went further by slashing its growth forecast for the

[1] Source; Bloomberg, January 2019.
[2] Source for all figures: Australian Bureau of Statistics, 2018.
www.abs.gov.au/AUSSTATS/abs@.nsf/mf/1345.0?opendocument

year to end of June from 3.25% to 2.5%, which again boosted Australian government bonds. The minutes from the most recent RBA interest rate setting meeting suggested elevated concerns around housing. In fact, the housing issue was discussed somewhat more than concerns surrounding China's growth outlook. The RBA is finally beginning to realise that there is a growing problem.

We believe it may take a while for the RBA to properly consider cutting rates soon. This stance should put further pressure on the longer end of the yield curve which could benefit the government bonds we have in the portfolio. The potential catalysts we are monitoring include additional growth downgrades and any evidence that the slowdown is starting to feed through into the jobs market, which currently meets the RBA's definition of full employment.

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