THE RISKS AND REWARDS IN AUSTRALIA & NEW ZEALAND DEBT

Bradley Krom – U.S. Head of Research
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The loudest argument we've heard for a prolonged pullback in bond yields in the United States (and around the world) has been the emergence of so-called "crossover buyers." In this scenario, investors from Europe and Japan, disillusioned by the low yields in their respective domestic markets, seek out the comparatively higher yields of U.S. bonds. While we take some issue with the simplicity of this argument, we fully admit that global competition for capital drives markets. However, with the U.S. poised to hike rates this year, we believe that other markets may provide more intriguing opportunities. In our view, two underappreciated alternatives for foreign capital may be found in Australia and New Zealand. In this blog post, we review our top three considerations for investors looking to understand risks and rewards in Aussie and Kiwi debt. **#1 – All-In Yields** In the table below, we compare five-year government bond yields from major developed markets around the world. Topping the list are New Zealand and Australia, followed by the U.S. and U.K. However, the U.S. and U.K. are both forecast to hike interest rates this year. From a relative value perspective, Australia offers yields that are over three times larger than Spain's yields. In New Zealand, bond yields are more than five and a half times larger than those in Italy. [1] While the U.S. tends to be mentioned most frequently as an alternative to negative yielders in Europe, current valuations in Australia and New Zealand appear compelling—based solely on income potential. **Five-Year Government Bond Yields: G-10 and Investment-Grade Europe**

Country	Yield to Maturity (%)
New Zealand	3.21
Australia	1.89
United States	1.49
United	1.22
Norway	0.79
Canada	0.72
Italy	0.57
Spain	0.57
Ireland	0.26
Sweden	0.18
Japan	0.05
France	0.05
Belgium	0.01
Finland	-0.04
Austria	-0.05
Netherlands	-0.05
Germany	-0.09
Denmark	-0.35
Switzerland	-0.47

Source: Bloomberg, as of 2/28/15.
Greece and Portugal were excluded due to non-investment grade credit ratings.

For definitions of terms and Indexes

in the chart, visit our glossary. **#2 – Interest Rate Risk** As we mentioned above, the Federal Reserve (Fed) and the Bank of England are both expected to hike interest rates at some point in 2015.[2] While the timing of these hikes remains uncertain, the assumption is that both of these central banks will hike rates before the central bank of either Australia or New Zealand does so. In fact, the Australian central bank has shown some willingness to actually cut rates in the coming months.[3] In New Zealand, after four consecutive 25-basis-point (bp) hikes in 2014, policy makers are shifting to a wait-and-see approach. With short-term interest rates higher than in many emerging market countries, New Zealand may provide some of the highest levels of income potential in the world. **#3 – Currency Risk via Commodity Prices** For many investors, currency risk has become a significant consideration in recent months. Over the last year, currency volatility has increased markedly. In fact, since June 2014, foreign exchange (fx) volatility has actually doubled, according to the J.P Morgan Global FX Volatility Index .[4] We expect this trend in increasing market volatility to continue across all asset classes. A primary driver of this trend is anticipated changes in central bank policy, but another significant contributor has been the precipitous fall in commodity prices. Historically, the value of the Australian and New Zealand dollars has tended to correlate to commodity prices and Chinese economic growth. The logic of this relationship holds that, given the large commodity wealth of both countries, China's sustained demand for commodities would naturally give support to their currencies. Over the last year, commodity prices have fallen dramatically. But while few are willing to call the bottom, it appears that Chinese economic momentum may be turning up. On February 25, preliminary Purchasing Manager Index (PMI) data, a measure of industrial output, showed an encouraging rebound. In response, after touching a six-year low on March 11, the Aussie dollar may be poised to rebound. Additionally, after trading at a four-year low in January, the New Zealand dollar has started to rebound.[5] At the end of the day, while both currencies remain near multiyear lows, investors don't necessarily need the currency to appreciate to capture attractive returns. As long as currencies don't depreciate by 2%?3% per year against the U.S. dollar, investors come out ahead. For European investors, in addition to much higher yields, both currencies remain in the lower third of their trading range against the euro. In our view, Australian and New Zealand debt appears attractively priced versus U.S. and European fixed income, due to higher yields and attractively priced currencies. [1]Source: Bloomberg, as of 2/28/15. [2]Source: Bloomberg, 3/6/15. [3]Source: Reserve Bank of Australia, 3/3/15. [4]Source: J.P. Morgan, as of 3/6/15. [5]Source: Bloomberg, as of 3/6/15.

Important Risks Related to this Article

Investments focused in Australia and New Zealand are increasing the impact of events and developments associated with the regions, which can adversely affect performance.

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DEFINITIONS

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Crossover buyers : Foreign investors buying positions outside of their home country.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Five-year government bond yields : The single discount rate that equates the present value of a government bond's cash flows to its market price which matures in 5 years.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Basis point : 1/100th of 1 percent.

Currency risk : the risk that an investment will decline in value due to a change in foreign exchange rates.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

JP Morgan Global FX Volatility Index : An index which tracks the value of options of emerging and developed market currencies.

Purchasing Managers' Index (PMI) : An indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A reading above 50 indicates an expansion of the manufacturing sector compared to the previous month; below 50 represents a contraction while 50 indicates no change.