Silverdale Funds

EMERGING MARKETS | USD BONDS | ASIA TILT

Overview

As expected, the US Federal Reserve hiked the policy rate by 25 bps in July'23, with (any) future rate hike being data driven. Fed commentary points towards potential of soft-landing scenario with lower inflation without deeper economic downturn, providing room for rate cuts. A picture-perfect scenario for fixed income: benefiting from lower treasury yields and tighter credit spreads.

Rate hikes working into economy

The Fed emphasized that the policy rates are *"in restrictive zone"* and that *"monetary policy is working as we expect"* that is, with a lag factor. It also implies, while peak policy rates will not automatically turn into rate cuts; yet the rate cuts are likely before inflation hits 2%. However, the shrinking of the Fed balance sheet would continue to affect the economy as that of additional rate hikes.

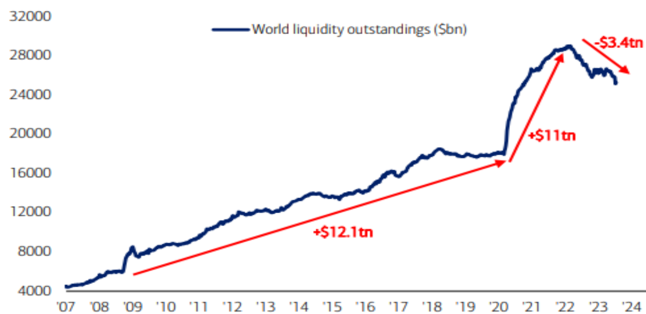

Figure-1: Money supply shrinking, but above pre-pandemic trend[1]

Inflation moderates; Labour market still tight

As mentioned in Silverdale June 2023 Commentary, over the next couple of months, headline inflation may move higher as the impact of the low base effect fades.

Figure-2 Average Workweek (Hrs): Below Long-term Average[2]

But the cracks in the labor market will continue to widen as seen from drop-in hours worked per week, now below long-term average, as well as decline in job openings, quit rates, and non-farm payroll.

After 25 months of negative real wage growth, the wages are rising faster than inflation, which is good for the overall economy, but nominal wages need to come down from the current level to avoid another round of inflationary pressure.

Figure-3 US Real Average Hourly Earnings (YoY % Change)[3]

Lending: Demand and Supply slowing down

The most-rate sensitive sectors are first to crack under the higher rates. The new mortgage and car loan applications have dropped sharply, while the delinquencies have risen to 2008 levels. The slowdown in the service industry (80% of GDP) is just about starting.

ECB: Rate hiked but watchout

As expected, ECB too hiked interest rate by 25 bps to combat higher inflation, despite a quarter of technical recession, in view of an ominous potential of wage-spirals, spike in food and energy costs.

BOJ YCC: Riding the tiger by the tail

After 30 years of deflation, holding highest amount of US Treasuries, and subsidizing global carry trade, the BOJ has finally bitten the bullet by announcing 50 bps *'leeway'* in Yield Curve Control. The stable doors have been opened. With 2% inflation but 10-year Japanese Government Bond at 0.50% +50 bps (now), it is still a

[1] Source: Fed, ECB, BOJ, BofA Research, Jul'23
[2] Source: US Census Bureau, Tradingeconomics.com Jun'23
[3] Source: CreativePlanning, Jul'23

baby step, but the path to normalization would be profound, long, and torturous for global assets.

China Politburo: Targeted support *(coming?)*

The Chinese Communist Party (CPC) Politburo meeting in July’23 announced (a) support to consumption of automobiles, electronics, and home-related goods as well as services; (b) adjustment of housing policies (removed the phrase *'Housing is for living, not for speculation'* from official statement); (c) structuring of local government debt; and (d) acceleration of infrastructure investment and supporting the private sector. It led to sharp rebound in Chinese risk assets from an extreme oversold position. However, sustained recovery will require policy specifics and actual implementation.

Bond valuations suggest potential for equity like returns with significantly lower risk

The massive repricing in interest rates since last year has resulted in higher credit (investment grade) bonds now offering equity-like potential returns, while continuing to provide capital preservation.

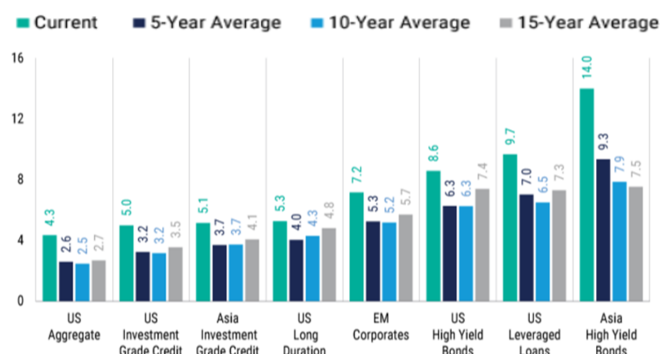

Figure-5 Credit Yields Are at the Highest Levels across the spectrum in over a Decade and Outstrip Long-Term Average (%)[4]

While corporate fundamentals may see some deterioration, higher starting yields provide cushion to investors.

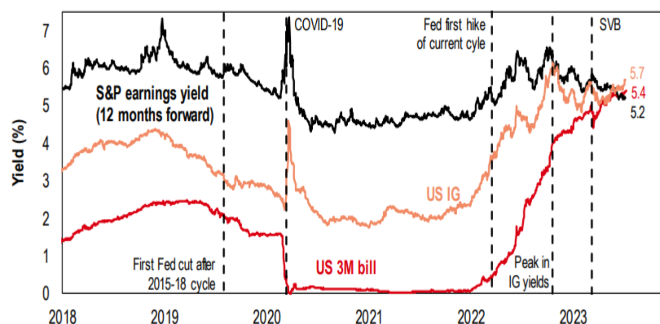

Figure-6 Yields on US IG and T-Bills is now comparable to earnings yield of S&P500[5]

Lock-in elevated yields, lower borrowing cost

To benefit from flight to high(er) quality bonds and eventual interest rate cuts, Silverdale Funds have increased the proportion of higher quality bonds, while cautiously increasing duration (to mitigate the effect of credit spread widening of lower quality bonds).

Over the long term, a leveraged bond portfolio provides superior risk-adjusted returns as compared to unlevered bond funds or equities. Currently, the cost of borrowing for (say) 4 years is almost 1.5% lower than the cost of borrowing for (say) 1 year. Hence, it is an opportunity to lock-in prevailing high yields, while locking-in relatively lower cost of borrowing to achieve superior risk-adjusted returns.

For July’23, the Bloomberg Emerging Markets Asia Total Return Index was down by about 0.5% and Bloomberg EM USD 1-3-year Index was down 0.1%; while Silverdale Bond Fund NAV was down by 0.5% and the NAV for various Silverdale Fixed Maturity Funds increased between 0.3% to 1.3%. Silverdale Bond Fund (78% high-quality Investment Grade bonds with leveraged YTM of 12.9%) as well as Silverdale Fixed Maturity Funds, have outperformed the indices and peer group. In view of strong investor interest, Silverdale Fixed Maturity Fund October 2026 is still accepting subscriptions:

Silverdale Fixed Maturity Fund: Oct’26

- Target net leveraged return: 8.75% to 9%
- Target distribution: US$ 6 p.a. paid half-yearly
- Target Maturity: Oct’26

Thank you for your confidence in us.

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[4] Source: PineBridge, Jun 2023

[5] Source: HSBC, Jul’23