# Silverdale Funds

EMERGING MARKETS | USD BONDS | ASIA TILT

## Helicopter View: 3Rs of 2022 to big R of 2023

*2022 was a story of 3Rs – rocked by* ***R****ussian invasion of Ukraine: sending energy shocks to the world and brutalized by* ***R****ate hikes: shooting up of 1-year US Treasury rate from 39 bps to 473 bps (1,113% increase!) resulting in the worst G-sec returns in 238 years! But resurrected by* ***R****e-opening of China and aided by inflation downticks.*

Today, the bond yields are the highest since 2008 with the US Investment Grade bond index yield around 5.4% as against S&P 500 expected dividend yield of c. 1.7%.

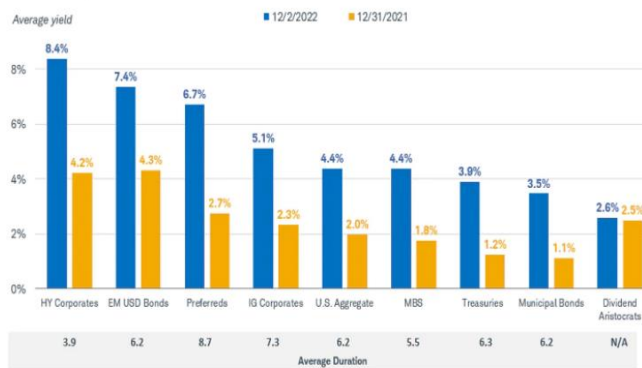


Figure-1: Attractive yield across asset classes[1]

As seen over the past 20 years, the bond yield is by far the most stable and reliable component of total return from bond portfolios, as follows:

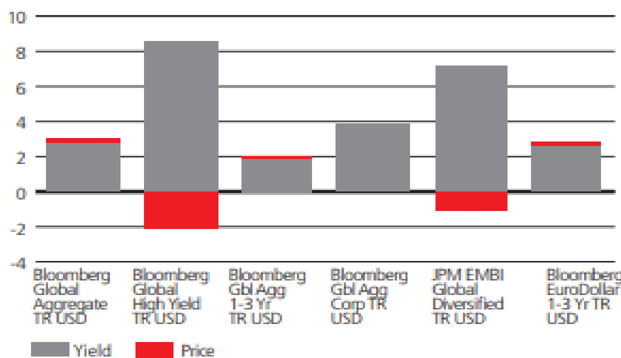


Figure-2: Fixed income returns broken down by price and yield over the past 20 years[2]

Hence, higher bond yield at the start of investment results in higher investor returns.

## Inflation down, Returns up

The headline inflation has dropped from the peak of 9.1% (in Jun'22) to 7.1% (in Nov'22) but the core inflation continues to be elevated and sticky around 6%. The largest component of core inflation is "Shelter" (c. 40% weight), data for which is collected once in six months, hence, lags prevailing rents by about 8 months. The sharp rise in mortgage rates (c. 7%) has induced the sharpest fall in property prices in 11 years, which in turn is feeding into sharp drops in property rents. The impact of these will be seen in CPI from late Q1 2023 onwards.

Bloomberg economists forecast headline CPI YoY to decline from 7.1% to 3.1% by end of 2023. Historically, over 1976-2022, when the CPI YoY decreases more than 1%, Bloomberg US Aggregate Bond Index has provided 6.1% average return.

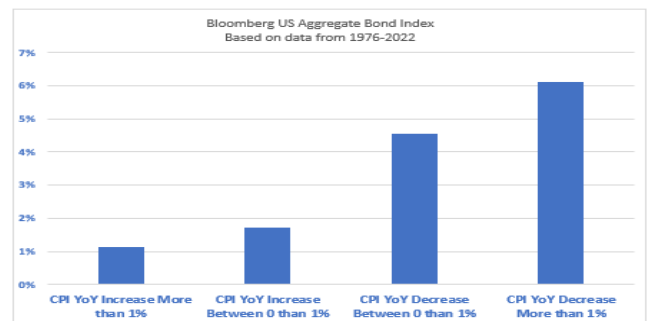


Figure-3: Performance of Bloomberg US Aggregate Bond Index During Periods When CPI YoY is increasing/decreasing[3]

## Unemployment Low: Interest rates peaked?

The labour demand peaked in the spring of 2022, however, it is still elevated with 1.7 job openings for every person unemployed, forcing employers to raise wages to attract workers.

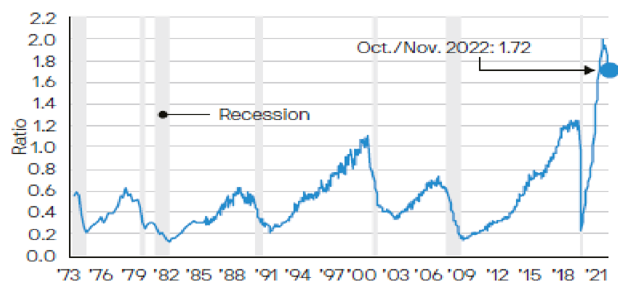


Figure-4: Job market and wages have peaked but remain elevated[4]

[1]Source: Bloomberg, Schwab Research
[2]Source: UBS Research
[3]Source: DoubleLine: 6month performance vs change in CPI YoY
[4]Source: JPMorgan

Historically, average unemployment rate at the time of Fed's last rate hike has been about 5.7% (currently 3.7%).

The markets have already priced-in peak Fed interest rate of nearly 5%. Hence, unless the peak Fed rate expectation changes, the impact of Fed rate hikes would be minimal. However, Fed balance sheet reduction (QT of $95bn per month), and normalization of monetary policy by ECB and BOJ will back-stop any sharp drop in bond yields[5].

## Investing prior to the final rate hike has provided strong returns

Historically, the fixed income yields have always peaked just before the last Fed rate hike, and investing in bonds for a year, starting six months prior to the last Fed rate hike, has provided a 5-year annualized total return of 6% to 16%, as follows:

| Last Hike | 6/2006 | 5/2000 | 2/1995 | 2/1989 | 9/1987 | 5/1981 |
|---|---|---|---|---|---|---|
| First 12 months return | 4.5% | 5.3% | 7.7% | 10.2% | 7.0% | 3.3% |
| Annualized total retrun over five years | 5.9% | 7.2% | 6.8% | 10.6% | 9.6% | 15.6% |

Figure-5: Five-year annualized total return based on monthly investment for 12 months starting six months prior to each of the last Fed rate hikes[6]

### Relatively lower risk

It is one of the rare times that US is entering into slowdown / recession on such a strong footing: (a) US Consumers have about US$ 1 trillion of excess savings from US Covid largesse; (b) Low Corporate Debt: The Investment Grade companies have very low Net Debt to EBITDA ratio of 2.1 times, even High Yield companies have Net Debt to EBITDA of just 3.6 times; and (c) Banks' balance-sheets are one of the strongest since the 2008.

As a result, credit default rates are below 0.84% as against long-term average of 1.5%. Mathematically, fixed income investors are being paid two-to-three times more than that attributable to the risks they are taking.

## China again a global growth engine?

In the past 50-days, China has removed most Covid restrictions, and the Chinese population is learning to live with Covid, like the rest of the world, this underpins the Politburo's 5% economic target for 2023. Also, more than CNY 3 trillion of credit lines targeting the real estate sector, support to technology sector, and removing hang-over over Macau gaming sector, provide further boost to Chinese credits. While reopening is a process, and not an event, but given very attractive valuations, Chinese assets provide huge alpha generation opportunities.

## December '22 Performance

As the credit markets started normalizing, the quality and resilience of Silverdale portfolios shone. For December 2022, the Bloomberg Emerging Markets Asia Total Return Index was up by about 5.4% and Bloomberg EM USD 1-3years was up 2.1%; while our flagship Silverdale Bond Fund NAV increased by 3.3% and the NAV for various Silverdale fixed maturity funds increased between 1% to 2%, net of fees and expenses.

## Takeaway: 2023 – The Year of the Bonds

Today's elevated bond yields offer an attractive entry point and provides a huge cushion to handle bond price volatility. The uneven economic growth rates provide compelling opportunities for active managers to uncover via bottom-up research and security selection. Inflation has moderated, and Fed rate hikes are likely to peak in not-too-distant future. Given the inevitable slowing of the economy with looming big "R" of Recession, the bonds would provide relative stability and higher returns.

Our flagship Silverdale Bond Fund (SBF) continues to be positioned to take advantage of the high carry offered by quality bonds, with 75% high quality Investment Grade bonds and duration of 1.6 years; yet, having leveraged YTM of 14.5%, pointing towards higher potential returns to investors. Notably, FMP2026 points to low double-digit net leveraged returns, and FMP August 2024 targets high single digit net leveraged returns.

We thank you for your trust in Team Silverdale.


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[5] Japanese investors own $2.4 tn in foreign investments.

[6] Source: Capital group