

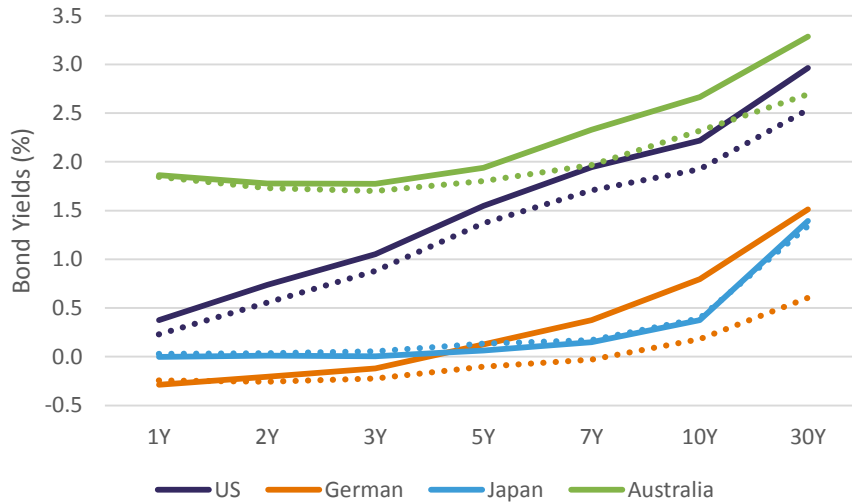


Government Bonds versus Cash

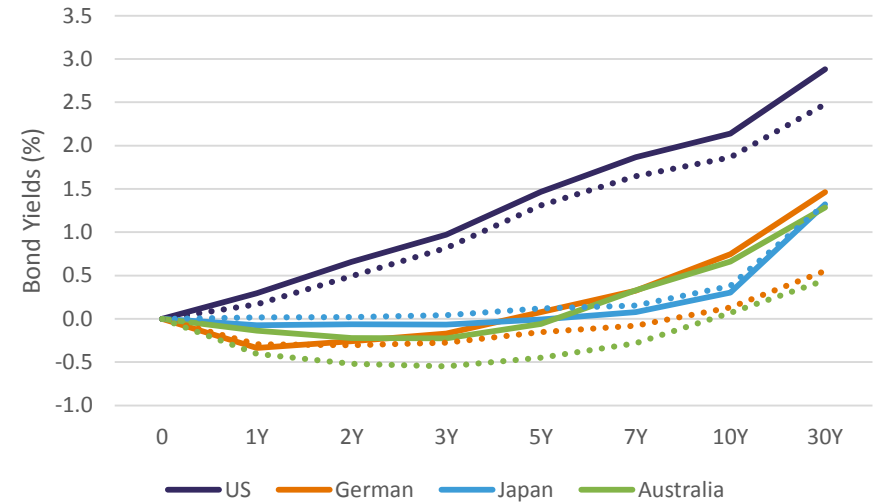
September 2015

YIELD CURVES

Bond Yields 31 March to 31 August 2015



Yield Curves 31 March to 31 August 2015



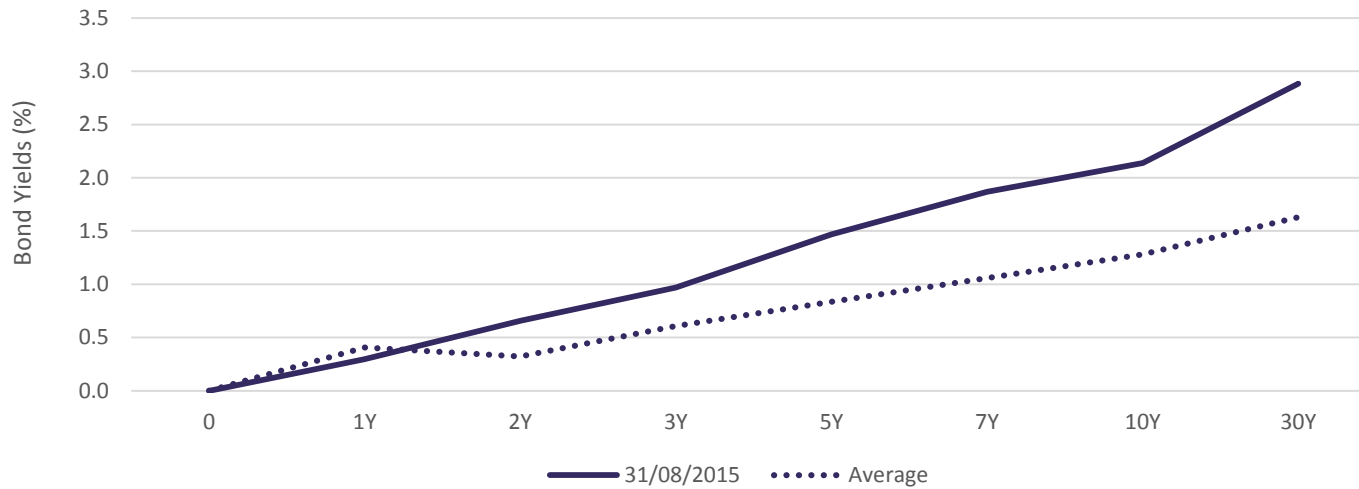
Dotted lines denote yields 31 March yields for respective colour-coded countries
Source: Bloomberg, Frontier

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- Bond yields have contracted somewhat since June 2015 but overall they have risen (except in Japan) since March 2015
- Yield curve (bond yield – cash rate) is materially steeper in the US
 - Australia's yield curve is more similar to Germany and Japan

YIELD CURVES

US Yield Curve versus Historic Average (1976-2015)

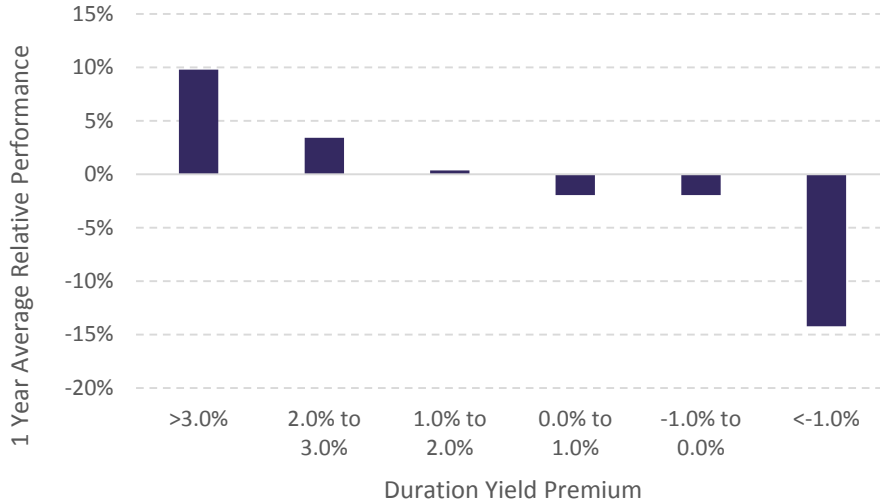


Source: Bloomberg, Frontier

- US yield curve is currently materially higher than historic average

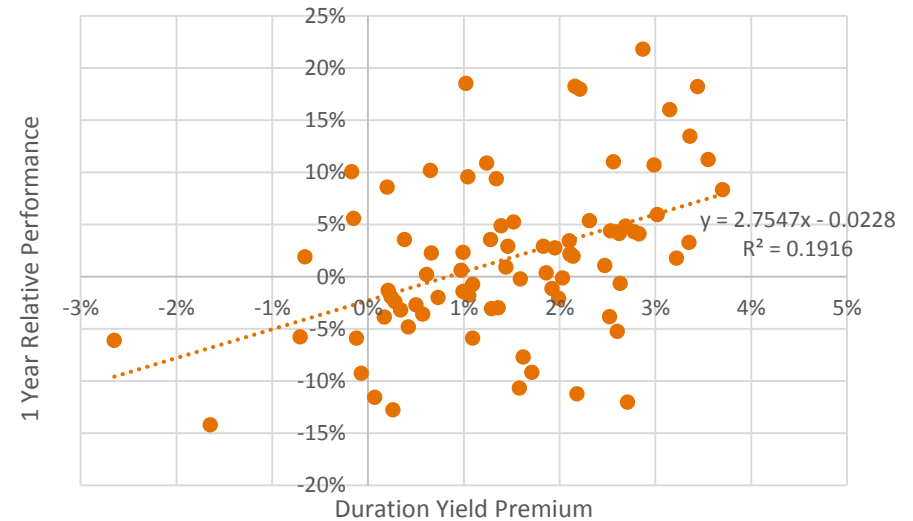
US BONDS VERSUS CASH

US 10Yr Gov Bonds v Cash 1934-2014



Source: GFD, Frontier

US 10Yr Gov Bonds v Cash 1934-2014

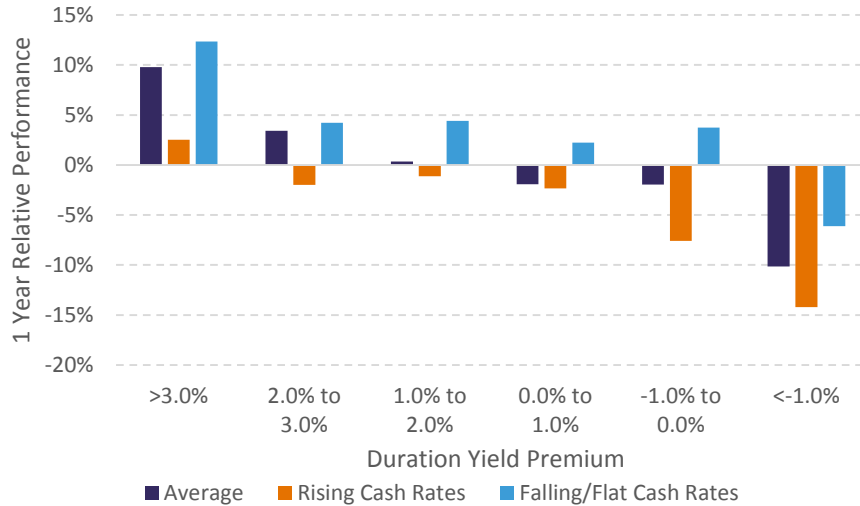


Source: GFD, Frontier

- Average relative return from government bonds versus cash increases as the duration yield premium (10 year government bond yield – cash rate) increases
- For example, when the 10 year duration yield premium is at least 2% on average, government bonds provide a higher return than cash in the next year
 - US 10 year duration yield premium is currently around 2.2%

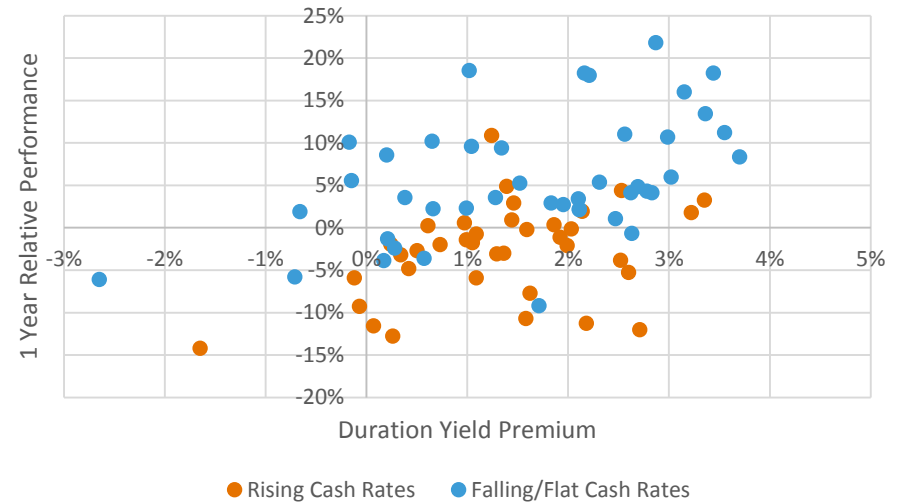
US BONDS VERSUS CASH

US 10Yr Gov Bonds v Cash 1934-2014



Source: GFD, Frontier

US 10Yr Gov Bonds v Cash 1934-2014

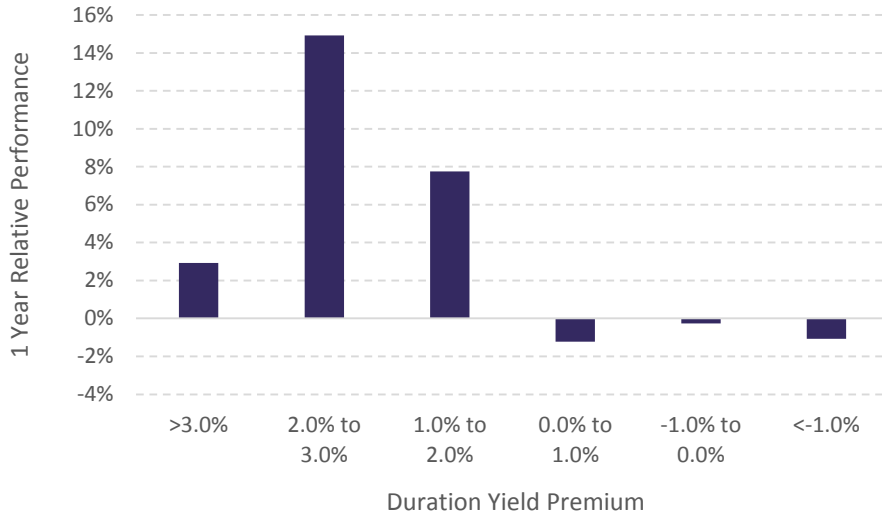


Source: GFD, Frontier

- However, the relative performance of government bonds versus cash is quite different in a rising cash rate environment (cash rate at end of year higher than at start of year)
- On average, government bonds underperform cash when cash rates are rising

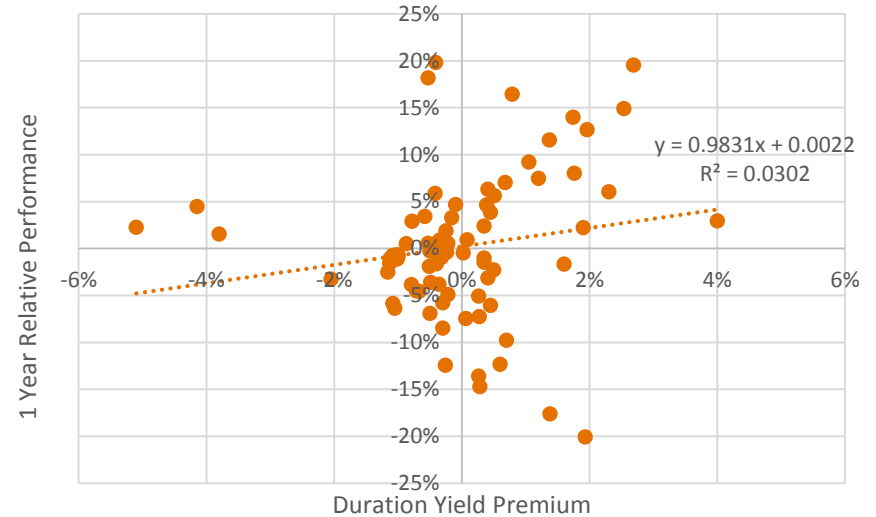
AUSTRALIA BONDS VERSUS CASH

Australia 10Yr Gov Bonds v Cash 1934-2014



Source: GFD, Frontier

Australia 10Yr Gov Bonds v Cash 1934-2014



Source: GFD, Frontier

- Average relative return from Australian government bonds versus cash is higher when the duration yield premium is higher
- But the relationship is much weaker than in the US
 - Not surprising as Australian bond yields are also strongly influenced by global (US) bond yields

CONCLUSIONS

- As expected – the yield of a bond is the key driver of future return
- The US yield curve is currently steep - relative to historical average and other developed markets
 - This provides support for US government bonds relative to cash
 - However, US cash rates are expected to rise from current zero bound and rising cash rate environment is generally negative for government bonds
- The Australian bond yield curve is flat relative to the US and closer to Japan and Europe
- Cash rates have been declining in Australia but the relatively flat yield curve provides limited support for Australian bond returns
- Continue to support negative tilt to government bonds
 - However, US bonds do not appear as negative relative to cash, particularly if the yield curve moved further higher and/or US cash rates only experience modest rises in the medium-term
 - A higher yield curve provides support to move some excess cash to underweight bonds

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