AMP Capital Investors Limited
ABN 59 001 777 591, AFSL 232497

Global Fixed Income Perspective

Prepared by Simon Warner

JUNE 2016

Simon Warner, Head of Global Fixed Income, offers his global view of fixed income markets, and insights into AMP Capital's portfolio positioning. Simon brings more than 20 years' investment experience together with a wealth of knowledge in macro markets, credit markets, commercial lending and protected growth.

Portfolio strategy and outlook

I have been visiting the US over the last week. First seeing some of my peers and some brokers in New York, then seeing the great group of AMP Capital people in Chicago. I finished in San Francisco where I met our technology partner. In the middle I had the chance to visit Minneapolis and see my uber talented sister-in-law play Mahler's Fifth Symphony.

There were two main themes to my trip. The first was the timing of the next US recession. Our indicators have been pointing to a more mixed outlook for the US economy over the last month or so. We had been in the camp that the weakness in Q1 was largely temporary and that the economy would accelerate in mid-year thanks to strong employment and a solid housing market underpinning the consumer. The recent softer employment number was surprising to us but not amazing in the context of the volatility of the series. Perhaps more noteworthy has been the broad-based ebbing of business confidence, especially in the service sector.

One of the economists that I saw was particularly worried about this as he saw it as an early signal that a bigger force may be at play. Corporate profits are slowing and pricing power is very low. As wages tick up a little the only way to maintain profit growth is to cut costs. This economist had expected this to be a force for 2017 but was wondering if it was happening sooner. This is not our base case but it's a risk we are very mindful of. These risks put more downward pressure on yields.

The second theme was political risk. This was primarily around the upcoming UK Brexit vote. As someone born in England I was asked my opinion. I feel unqualified to answer that as I been away since 2000, however, I would be very surprised to see an exit and think the Scottish referendum is a solid template for thinking about a preference for the status quo. My strongest view is that the quality of the debate has been woefully poor and I wonder if this reflects a broader distrust of "experts" since 2008. The upshot is higher political risk and lower bond yields.

This brings us onto Donald Trump, who embodies this broader lack of trust in expertise. Everyone I met in the US had the same opinion of Donald. This should tell you more about the homogeneity of the people I met rather than the election outcome. Mark Twain said that anytime you find yourself in the majority it should give you pause to reflect. I am in the majority on my view of Trump but think that as we move into September, political risk will be priced into the US. Even more downward pressure on yields!

I'll recommend two movies this month. Death in Venice (Visconti, 1971) is a work of art with Dirk Borgarde, a beach and the fore-mentioned Mahler's Fifth. The second one is It (Wallace, 1990). I have always found clowns creepy and this movie – where a monster takes the form of a clown to entice victims in before changing to their worst nightmare and devouring them – didn't help that perception when I was a kid. I'll let you draw your own analogy to Donald Trump.

Macroeconomic review

US data was mixed with weaker manufacturing conditions in April and soft payroll employment, but stronger services sector conditions, stronger construction activity, and a smaller trade deficit. There was a big gain in April retail sales, improved consumer sentiment, a rise in small business optimism and strong data for job vacancies and hiring suggesting that the labour market is strong and the slowing in payrolls seen in March may be an aberration. Meanwhile, a rise in producer prices suggests an edging up in underlying price pressures. There were softer readings in regional manufacturing conditions surveys and a bounce in industrial production in April after two months of falls. Home builder conditions and housing starts are trending sideways but there was a fall back in jobless claims and stronger leading economic indicators and existing home sales. Consumer price index inflation bounced in April due to higher oil prices but core inflation dipped slightly to 2.1% year-on-year. Business conditions purchasing managers' indices slipped in May and core durable goods orders were weak in April. However against this home prices continue to rise, new and pending home sales surged, the advance goods trade balance for April was better than expected, jobless claims fell again and March quarter gross domestic product growth was revised up slightly to 0.8%. The overall impression remains that US growth has bounced back in the current quarter with the Atlanta Fed's GDPNow gross domestic product tracker now running at 2.9% annualised growth. The message from the US Federal Reserve remains that an interest rate hike is getting closer, but July still looks more likely than June.

In Europe, economic data remains mixed and fairly steady. During the month it was reported that in March eurozone industrial production fell -0.8% but German factory orders rose. Purchasing managers' indices generally fell in May, but only fractionally and they continue to point to moderate growth. March retail sales fell -0.5% and are now tracking a slightly lower annualised growth rate of 2.1%. The Sentix Investor Confidence index for May rose from 5.7 to 6.2, higher than consensus expectations. Consumer confidence also increased more than expected in May but remains in negative territory. April consumer price index inflation rose just 0.1% with annualised inflation at 0.3%. Geopolitical concerns remain regarding the upcoming "Brexit" referendum; although opinion polls are finely balanced investors are more mindful of financial odds that appear to be edging more decisively (an implied 70-80% likelihood) in favour of a remain outcome. Greece, the European Union and the International Monetary Fund agreed a new debt deal which will see €10 billion disbursed. This is good news because it means there won't be another "Grexit" scare this northern summer. Bond yields in Spain and Italy fell in response.

Chinese business conditions and purchasing managers' indices fell back slightly in April. They remain above recent lows and the moves were too minor to assign much weight. Following the lead from business conditions purchasing managers' indices, Chinese industrial production, retail sales, fixed asset investment, exports, imports, lending and money supply growth all slowed to varying degrees in April, leaving them in the growth ranges they have been in over the last year or so. It's clear that there is no sustained acceleration in Chinese growth, but then again there is no collapse either. More likely it will stabilise around the 6.5 to 7.0% gross domestic product growth range. Chinese consumer price index inflation was unchanged at 2.3% year-on-year in April, with non-food inflation remaining low at just 1.1% yoy. There was good news though with producer price deflation continuing to recede from -4.3% year-on-year to -3.4% year-on-year. Meanwhile, the decline in underlying foreign exchange reserves continued to slow suggesting that capital outflows are continuing to slow as a degree of stability has returned to the Chinese renminbi. China saw the housing market continue to hot up in April, particularly in Tier 1 cities as inventory levels continue to fall. The People's Bank of China moved to try and dampen down concern about the sharp slowing in credit seen in April indicating that the drop was temporary and that it will continue to support growth.

Japanese gross domestic product rose more than expected in the March quarter as did machine orders but growth has been bouncing between positive and negative quarters against a zero growth trend for the last year now and the Kumamoto earthquake may create a headwind in the current quarter. There was a further fall in the May manufacturing conditions purchasing managers' index to a weak 47.6 and a higher trade surplus due to weaker imports. Meanwhile, national core inflation remained low at just 0.7% year-on-year in April, with Tokyo data pointing to a further fall in May.

Australia was the latest economy to reduce interest rates, cutting its rate to a record low of 1.75% on 3 May against a background of deflationary concerns and record low wages growth. In explaining the move, the Reserve Bank of Australia cited unexpectedly low inflation data and a lower outlook for inflation than had been previously forecast. While the Reserve Bank of Australia seems reasonably content with the rebalancing of the economy, it is clearly concerned that if it doesn't act quickly then low, sub-target inflation as we have seen recently will start to feed through to inflation expectations and become self-perpetuating. The Reserve Bank of Australia also referred to an appreciation in the Australian dollar complicating the economic adjustment in the economy. April economic data released during the month showed a bounce in building approvals, albeit with the trend remaining downwards. However, March quarter construction and capital expenditure fell, driven by the ongoing reduction in mining investment and is likely to remain an ongoing detractor from growth. There was a sharp improvement in the trade deficit exhibited in the latest figures for March. Net exports contributed approximately 0.75% to the March quarter gross domestic product growth as resource export volumes, along with services exports, surged over the period. Concerns regarding an overheated property market also remained, with some banks tightening residential loan criteria, especially for foreign investors.

Markets review

Although a volatile and sentiment driven market was still very much in evidence during May, there was a risk-off bias towards the tail-end of the month. Both equities and fixed income securities posted good returns for the month. The main concern was the upcoming US Federal Reserve June meeting and the statement that it will be 'live', meaning that a further interest rate hike will be actively considered if the data is supportive. Prior to this statement the market consensus was that a June interest rate hike would be unlikely as US data has been variable. There therefore remains significant room for manoeuvre, with an interest rate hike by no means assured or even likely in June. Uncertainty remains regarding the UK's upcoming 'Brexit' referendum in June to decide whether it will remain in the European Union. Meanwhile, the European Union and International Monetary Fund agreed a new debt deal with Greece towards the end of the month.

May saw oil develop a more stable base and, together with a more positive commodity backdrop, should provide some support for global energy and commodity sensitive stocks.

Iron ore was less positive, resuming its slide and falling below US$50 a tonne.

The Global Fixed Income team's blended credit spread, a barometer which measures global physical credit spread movements, was three basis points tighter over the month, led by tightening in Australian investment-grade and global high yield. The Australian investment grade market was four basis points tighter over the month. Global high yield spreads were 27 basis points tighter, continuing their strong performance since the mid-February wide point in spreads.