AMP Capital Investors Limited
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AMP CAPITAL

# Global Fixed Income Perspective

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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

In my last update I wrote about the likely persistence of political risk and that it is a factor that is likely to depress economic growth and bond yields in the months to come. I did not expect political risk to be the primary driver of asset prices in June though!

The outcome of the 'Brexit' vote – that the UK has decided to leave the European Union – was a shock to me. Perhaps it shouldn't have been because rising inequality and the impact of globalisation on median incomes in developed economies has been a subject that I have been studying for several years. However, I did not expect that the British would vote themselves into a likely recession.

When we think about the impact of the vote on financial markets we look to our investment process and indicator set to provide guidance. The main initial impact has been in the British pound. Prior to the vote we saw fair value in the British pound/US dollar exchange rate as about 1.35 so it was not surprising to see a big fall. Indeed, we see further downside. We will then be watching our 'surprise' indices and economic pressure indices to judge the immediate economic impact in the UK. The stimulatory impact of currency depreciation typically works with a lag so we think that there will be a sharp slowdown in growth in the second half as businesses hold back investment. There is a better that even chance of a recession in the next year but we will be watching the data to confirm that assessment.

The secondary impacts on global growth are best seen through our financial conditions and policy conditions indices. So far the country most affected is Japan with a much weaker Nikkei and stronger yen. We think more easing is needed, and is coming, in Japan.

Finally, the other transmission mechanism we are watching is through the European financial system. Linden Smith, our financials analyst, has been following the vulnerability of Italian banks for some time and was quick to identify them as the possible link from Brexit to the Euro-area. Italian banks have poor profitability, poor asset quality, poor transparency around non-performing loans and a legal system that makes disposing of assets very difficult.

Our assumption is that the system needs recapitalising and that because the court system is so cumbersome, new capital is likely to be needed from the Italian government. This raises all sorts of questions about national sovereignty, the resolution regime in Europe, the effectiveness of regulation and the path of policy. Markets so far have been sanguine about the wider effects of problems in Italian banks but this is a risk we believe is under appreciated.

European credit markets sold off on the day the Brexit outcome was revealed but subsequently rallied hard. We sold down risk into that rally but remain somewhat overweight credit. We have lots of room to add if the Italian situation deteriorates and non-financial spreads are dragged wider.

What movie can I recommend that is at all relevant? My favourite (non-Bond) British movie is The Third Man (Carol Reed, 1949) but I am also a great fan of the 1950s comedies. In Passport to Pimlico (Cornelius, 1949) an old treaty is discovered that allows Pimlico to declare independence. Wishful thinking I suppose. I challenge anyone to watch The Mouse That Roared (Arnold, 1959) and not see the parallels between Prime Minister Count Rupert Mountjoy's (Peter Sellers) strategy and that of Boris Johnson. "Only an imbecile could have won this war, and he did!"

## Macroeconomic review

For much of June, markets were focussed on the UK's 23 June referendum over whether it would leave the European Union or remain. In a shock for financial markets, which had been increasingly confident that Britain would vote

“Remain”, a victory for the “Leave” outcome by 52% to 48% triggered an abrupt bout of “risk off” sentiment and activity in financial markets. For the UK economy, the outcome is bad news. According to estimates from the UK Treasury and the Organisation for Economic Co-operation and Development, the impact on trade, the financial sector and labour mobility could leave the UK economy 5% or so smaller than otherwise in 15 years’ time. In the short term there is a risk of recession, given the blow to business confidence as UK businesses will be uncertain about their continued access to the European Union. The negative impact on the UK economy will be partly offset by a weaker British pound, making UK businesses more competitive, and easier than otherwise Bank of England monetary policy. But political uncertainty won’t help, with Prime Minister David Cameron to step down by October, uncertainty over the leader of the opposition Labour Party, pro-European Union Scotland pushing for another independence referendum and some in Northern Ireland pushing for integration with Ireland.

US economic data was mostly good. While durable goods orders were weak, the June manufacturing purchasing managers’ index rose, home prices rose, home sales were strong and jobless claims fell sharply. The US’s top 33 banks passed a US Federal Reserve stress test, indicating that they have enough capital to withstand a severe economic shock (involving unemployment doubling to 10%) – in other words they are in good shape to withstand any shock flowing from Brexit. There was a surprisingly solid increase in the June manufacturing conditions ISM index, good growth in consumer spending for the second month in a row in May, a rise in consumer confidence, the June services purchasing managers’ index was flat at 51.3 and jobless claims remain low. While pending home sales and trade data were weaker than expected, March quarter gross domestic product growth was revised up to 1.1% annualised and June quarter growth looks to have rebounded to around 3% annualised. The May labour market report was much weaker than expected, with payrolls up just 38,000 and wages growth stuck at 2.5% year-on-year. While unemployment fell to 4.7% this was only because participation fell. The US Federal Reserve remains on hold and very dovish, allowing for global risks. It revised growth forecasts down fractionally to 2% for this year and next and slightly upgraded its inflation forecasts, but it was a bit less positive on the US jobs market.

The European Central Bank remained in implementation and assessment mode at its June meeting, but the bank’s continuing sub-target inflation forecasts and President Mario Draghi’s dovish comments indicate it retains an easing bias. Eurozone economic confidence improved for the second month in a row and remains at levels consistent with continued economic growth, unemployment remained high at 10.21% and bank lending continued to increase modestly. Eurozone March quarter gross domestic product growth was revised up to 0.6% quarter-on-quarter, further confirming that growth is continuing at a reasonable pace. The Eurozone composite business conditions purchasing managers’ index fell slightly in June, with a decline in services offsetting a gain in manufacturing. It remains at a level consistent with moderate growth though. Eurozone economic sentiment fell only slightly in June and remains consistent with moderate growth and a pick-up in bank lending growth is a positive sign. Inflation rose slightly in June but remains low at 0.1% year-on-year for headline and 0.9% year-on-year for core inflation.

Chinese data released in June for May was mixed with slowing growth in investment but stable growth in retail sales and industrial production. Combined with stronger exports and stable business conditions purchasing managers’ indices, growth looks to be tracking at 6.5% to 7% per annum but policy looks like it will have to remain stimulatory. Chinese exports fell 4% year-on-year in May, which was in line with expectations, but the fall in imports moderated to just -0.4% year-on-year which is indicative of higher commodity prices and possibly improved domestic demand. Meanwhile, consumer price inflation fell to 2% year-on-year but producer price deflation continued to abate which is a good sign. Chinese business conditions purchasing managers’ indices for June were little changed and consistent with growth running around 6.5% to 7%.

As widely expected, Japanese Prime Minister Shinzo Abe delayed the scheduled second increase in its sales tax rate to October 2019, with fiscal stimulus likely to be announced in the months ahead. With inflation well below target, shaky growth and the Japanese yen now rising to a 12-month high, pressure remains on the Bank of Japan for additional quantitative easing. Meanwhile, labour market data for April was solid and industrial production rose (though still trending down on a yearly basis) and household spending remains weak. Japanese March quarter gross domestic product growth was revised up slightly to 0.5% quarter-on-quarter from 0.4%. April machinery orders and May economic sentiment were both weak. Japan’s manufacturing conditions purchasing managers’ index rose by just 0.1 to a still weak 47.8 in June. Finally , Japanese jobs data for May remained strong, housing starts rose and the June quarter Tankan business conditions survey was little changed, but May data for household spending and industrial production were soft and core inflation slipped further to just 0.6% year-on-year , adding to pressure for more stimulus.

Following its last meeting, the Reserve Bank of Australia expressed a degree of comfort with current interest rate settings, and while Brexit-related risks have added to the case for another interest rate cut, at this stage the Reserve Bank of Australia is likely in ‘wait and see mode’. Australian data remains consistent with subdued economic growth. Gross domestic product growth was 1.1% in the first quarter of 2016, leaving annual growth at 3.1% – well above the estimates for trend growth (now approximately 2.75%) and above economists’ forecasts of 0.8% for the quarter. The external sector contributed a very significant 1.1% to growth due to stronger resource volume exports and a fall in imports. Australian retail sales rose by 0.2% in April and annual growth was unchanged at 3.6% . The soft outcome was due to a fall in food retailing. Lower spending in food has been evident for a few months now and is the result of greater supermarket competition driving prices lower. Consumer confidence weakened a little in June but remained positive. The Reserve Bank of Australia rate cut in May had a very large positive impact on confidence readings in May and this was expected to fade in June. However, the survey was taken in the week that consumers heard news about the Reserve Bank of Australia keeping the cash rate unchanged and news on the better-than-expected gross domestic product growth number. Consumer confidence continues to be weaker than business confidence – a trend that has been constant for a few years. Finally, Australian employment increased by 17,900 in May – a little above the market consensus of 15,000. The unemployment rate was unchanged at 5.7%, with the participation rate also unchanged at 64.8%. Jobs growth has slowed from the high levels seen in 2015, but the unemployment rate is still lower than where it was a year ago. Given the structural change occurring in the economy, this should be considered as a positive outcome.

## Markets review

June was dominated by concerns over event risk. The UK referendum, on 23 June, resulted in a decision to leave the European Union. The result blindsided global markets, which had largely factored in a decision to remain, and led to an immediate risk-off stance. The decision has also brought into focus current dissention within the European Union and fears that it may lead to contagion, with some European political parties now openly suggesting other member countries should also conduct a similar referendum. The British pound and shares fell sharply immediately following the decision, as did the euro and European shares, albeit to a lesser extent. Global shares were also swiftly impacted. Safe haven assets including gold, the US dollar, the Japanese yen and bonds all rose. Following the decision, central banks were quick to emphasise they would provide whatever liquidity is required to stabilise markets.

Although the UK referendum result eclipsed other economic events during the month, there was nevertheless the resolution of some other important issues. The German constitutional court validated the European Central Bank's Outright Monetary Transaction programme. The programme underpins the European Union's commitment to do "whatever it takes" to preserve the euro and therefore provides some relief in the current uncertain global economic environment. The Spanish general election on 26 June failed to deliver a majority for either main party or alliance, in line with the market's expectations. This will likely lead to a continuing centre-right minority government that will struggle to pass further reforms but won't see earlier substantial reforms unwound. The UK referendum decision, and associated uncertainty, also means the timing of US interest rate rises is likely to be pushed out further.

The Global Fixed Income team's blended credit spread, a barometer which measures global physical credit spread movements, was seven basis points wider over the month, led by European and high yield as the main underperformers, whilst US and Australian investment grade spreads were also dragged wider. The Australian investment grade market was five basis points wider over the month. Global high yield spreads were 12 basis points wider, offsetting some of their prior strong performance since mid-February.