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

GLOBAL FIXED INCOME PERSPECTIVE

APRIL 2017

Simon Warner, Global CIO, 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

Last month I wrote about how global government bond yields were in the process of retracing the sell-off from November. That trend continued in April and reached levels where our indicator set has again guided us into a short duration position. We shortened duration at levels equivalent to about 2.25% in the US 10 year bond. We are trading the range. Our base case is that the 10 year bond will trace out a 2.25-2.75% range in coming months. We would most likely buy back duration at above 2.50%. We will stop on a clean break of 2.20%.

I am still surprised by the widespread view that bond yields will inevitably rise dramatically at some point. I do not see this as inevitable at all. This view is generally rooted in some concept of yields reverting to long run averages. We prefer to assess valuations through multiple perspectives that include global relative value and cyclical elements. A sustained break higher in bond yields is certainly possible but it would require a meaningful change in the inflation outlook and hence central bank policy settings.

Also, don't forget that being short duration costs performance every day as you forego higher yielding longer duration securities.

We are short the Australian dollar. We see ongoing risk in the Australian economy with commodity prices softening and house prices flattening out. Australian consumption has been propped up by the wealth effect of housing in the last few quarters while underlying income growth has been soft. The rebalancing of the Australian economy towards new sources of growth is not finished yet. A weaker currency would be helpful for this rebalancing but it trades stubbornly high relative to the recent falls in export prices. We are short from around US75.5 cents with a target of US72 cents and a stop above US76 cents.

In credit we are less tactical. Credit spreads have narrowed significantly over the last year and over the last few months. Australian spreads have outperformed the rest of the world. We have sold into this credit rally with a portfolio that is now of higher quality, shorter tenor, and higher liquidity. There is limited scope for further narrowing and we think that it is dangerous to chase the market at these valuations.

I haven't had time for movies in the last month so I am going to recommend one actor, a TV show, and an upcoming movie. Kamail Nanjiani is great. If you haven't seen Silicon Valley on TV then you should, it's the best thing on TV and the fourth series is starting soon. He is also in an upcoming movie that I am excited about called The Big Sick. It is based on the true story of now Nanjiani met his wife and looks brilliant.

MACROECONOMIC REVIEW

Geo-political events came to the fore again during April. Political developments in France were closely watched as a broader indication of the direction and long-term viability of the European Union. The major French political parties have, over recent months, come under increasing pressure following a slew of failings, including alleged dishonesty and an inability to resolve some of France's more pressing and fundamental social and economic problems. The first round of presidential elections resulted in centrist Emmanuel Macron and Marine Le Pen on the right progressing to the second stage. European markets and the euro reacted favourably as Le Pen claimed second place and aggregate future voting favours pro-European Macron. Tensions in Asia continue to increase, with North Korea's increasingly erratic behaviour raising instability and armed-conflict concerns in the region. In the UK, the British Prime Minister announced a snap-election for 8 June, following significant leads in polls and a weak opposition.

In the US, there was continued uncertainty on how the administration will implement its policies and the overall economic impact when the Federal Reserve starts to shrink its balance sheet. The Trump administration proposed a reduction in the federal corporate tax rate from 35% to 15% and a simplification of individual tax rates, although these will need to be approved by Congress. It has also proposed special provisions to enable companies to repatriate funds held overseas back to the US at favourable rates. Full details of the revised tax codes have yet to be disclosed. US economic data was generally positive during the month, particularly in regards to jobs data, construction spending and home sales.

In Asia, Japanese Tankan business conditions survey showed continued improvement for the March quarter, as did March composite conditions purchasing managers' indices. Labour market conditions were also relatively benign. The Bank of Japan remains accommodative, keeping interest rates on hold as expected. In China, March quarter gross domestic product data came in better than expected.

Aside from the US, there are no immediate signs in key economies that accommodative monetary policies will be wound-back in the near term.

In commodities, iron ore and oil prices came under pressure during the month on over-supply concerns. However, the International Monetary Fund released its World Economic Outlook, raising its global growth forecasts to 3.5% in 2017 (up from 3.4% previously) and 3.6% in 2018 (unchanged from prior estimates).

The April Reserve Bank of Australia (RBA) Board minutes noted that the "developments in the labour and housing markets warranted careful monitoring over coming months" and there were no immediately obvious solutions to the affordability issues, particularly within the Sydney and Melbourne markets. However, despite property prices being of concern, there are few signs of significant wage or producer price inflation; with capacity utilisation below trend, there is unlikely to be pressure to raise rates in the near term. Headline inflation is now within the RBA's target 2-3% target band but underlying inflation is still low and below the band at 1.8%.

The market awaits the May federal budget to see what measures will be taken in regards to, amongst other things, housing affordability and debt management. However, many of the economic forces at play are out of the government's control in the short term and there remains the risk that ratings agencies will take a negative view on any significant increase in debt obligations.

MARKETS REVIEW

US 10-year Treasury yields fell back from 2.39% at the start of the month to close in slightly lower at 2.28%. This was the result of heightened geo-political tension and weaker March data relating to retail sales and consumer price index inflation at the start of April. Sentiment turned more positive later in the month following news of the US administration unveiling plans to make significant cuts to US corporation tax. Japanese and UK ten-year government bonds also fell, finishing at 0.01% and 1.09% respectively. The spread of French government bond yields relative to German debt reduced as the risk of a French euro exit diminished following the first round of the French presidential election. The abatement of deflationary pressures as commodity prices trend up, the gradual using up of spare capacity and a shift in policy focus from monetary to fiscal stimulus indicate that the long-term decline in yields since the early 1980s is probably over.

Australian yields continue to trade at a premium to those available in Japan and Europe, making Australian sovereign fixed income and corporate credit relatively attractive from an international perspective and for yield-hungry investors. Australian government bond yields fell moderately during April, finishing the month between 8 and 14 basis points lower across the yield curve, with declines progressively greater up to the 5-year maturity point. Longer-dated yields posted more modest declines, with the 30-year bond yield ending the month eight basis points lower. The last 12 months has seen the Australian yield curve steepen, with 3-year bonds yields marginally lower and 10-year yields trading 0.06% higher over the year. Australia remains well behind the US in moving into an interest rate tightening cycle.

The Reserve Bank of Australia again held rates steady at 1.5%, as it continues to balance Australia's lacklustre inflation rate against rising private debt levels and exuberant residential property markets in Sydney and Melbourne. The decision was in line with investor expectations and had little impact on money markets which continue to expect that there will be no rate change throughout 2017. Three and six-month Australian bank bill rates closed incrementally higher, at 1.75% and 1.96%, respectively.

The Global Fixed Income team's blended credit spread, a barometer which measures global physical credit spread movements relative to government bonds, was in aggregate marginally tighter across the month. Spreads on US investment grade corporate issues tightened by one basis point and Australian spreads remained unchanged. Global high yield market spreads were 12 basis points tighter over the month, partially retracing the prior month's underperformance.

CONTACT DETAILS

If you would like to know more about how AMP Capital can help you, please visit www.ampcapital.com