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

GLOBAL FIXED INCOME PERSPECTIVE

Prepared by Simon Warner

AUGUST 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

The Reserve Bank of Australia (RBA) cut rates again this month in Glenn Stevens' last meeting as Governor. This prompts two key questions in my mind: How low can policy rates fall in Australia, and; will Phillip Lowe, the new Governor, bring any change in the RBA's approach to monetary policy?

We have been relatively downbeat on the Australian economy for several years now. We have had a core view that the rebalancing of the economy away from mining investment would require ongoing lower policy rates from the RBA. This has been correct. Our more upbeat view on the US economy has also been correct. (The big thing that we have got wrong has been the US Federal Reserve!)

Given that the RBA has now delivered cuts to our long standing target of 1.5% it vital that we test ourselves and ask if we are at a low. We think that the coming months represent the period of maximum risk for the economy and the unwinding of the investment boom. Consumption has always been central to the stability of the economy and recent retail sales numbers have been poor. In addition, the stability of the Australian dollar means that the support to the economy from the currency will ebb. On the plus side, the end of the fall in mining investment is now at last in sight and the fading of this headwind into 2017 is very important.

The conclusion of this is that (absent a shock from somewhere) we could be at the end of the rate cutting cycle. Maybe, but don't hold your breath!

The September RBA board meeting will be the first in 16 years that Glenn Stevens will not be part of the decision making group. That is quite a change and warrants our reflection.

The modus operandi for all new central bankers since Paul Volker has been to be hawkish early, anchor inflation expectations and foster growth through stability. The second half of that statement still applies to Phillip Lowe but the challenge early in his term will be to stem the entrenchment of disinflationary expectations. He will certainly be keen that Australia's Achilles heel of excessive personal debt accumulation does not define his governorship.

There is one more RBA rate cut priced into the front end of the yield curve. With this buffer in place and the potential abatement of headwinds that I mentioned before, this risk looks fully priced for now. We are slightly short duration and will add if our technical indicators flip.

How low will rates go has been the topic this month. A movie on a related theme that I can recommend is The Big Blue (Besson, 1988). A film about two childhood friends and their rivalry in the world of free diving. It has wonderful camera work, a terrific score and a photogenic star in Jean-Marc Barr.

MACROECONOMIC REVIEW

US economic data released during the month was generally good. There was a very strong rebound in June payroll employment, continuing low jobless claims and the ISM non-manufacturing index rose to 56.5 in June. Jobs growth averaged 147,000 a month over the second quarter telling us that the US economy is doing well. There were stronger than expected gains in retail sales and industrial production, a slight rise in small business optimism and continued strong data on job openings (albeit down slightly) and hiring and ultra-low jobless claims. Core consumer price index inflation rose 2.3% over the year to June, adding to evidence that deflationary risks are receding. Housing data was strong (with solid readings for home builder conditions, starts, sales and home prices), leading indicators rose more than expected and the Markit manufacturing purchasing managers' index rose solidly in July. Towards the end of the month data was a bit mixed with stronger than expected consumer confidence and new home sales and continuing low jobless claims, but soft durable goods orders, pending home sales, gross domestic product growth and employment cost growth. June quarter gross domestic product growth disappointed at just 1.2% annualised. In terms of equity markets, solid June quarter results are providing evidence that US profits may have stabilised. US Federal Reserve officials have been sounding more relaxed about the US economy after the release of solid economic data and regarding the impact of Brexit.

In Europe, markets generally have moved on from the initial panic reaction seen in the days immediately after the Brexit vote. Fears around Brexit's global impact look to have been exaggerated – the only lasting impact so far has been the fall in the value of the British pound, reflecting the negative impact of Brexit on the UK economy. As expected the European Central Bank remained in wait and see mode at its July meeting. However, President Mario Draghi referred to greater uncertainties in reference to Brexit and reiterated the European Central Bank's "readiness, willingness and ability to act" if necessary. Eurozone business conditions purchasing managers' indices and consumer confidence fell slightly in July suggesting little impact on confidence and conditions from Brexit. They remain at levels consistent with moderate growth. The European Central Bank's bank lending survey showed an increase in demand for loans and a further easing in lending standards which is also a good sign as the survey was conducted both before and after the Brexit vote. Eurozone June quarter gross domestic product growth slowed to 0.3% quarter-on-quarter or 1.6% year-on-year, down from 1.7% year-on-year and July core inflation was unchanged at 0.9% year-on-year. It's not so good for the UK where its purchasing managers' index fell sharply in July following Brexit, adding to evidence it may be heading into recession. Confidence readings in the UK also continue to come in very weak post Brexit. Finally, the results of the latest European large bank stress tests were better than expected with only Italy's Banca Monte dei Paschi di Siena and Ireland's Allied Irish Banks not satisfying the test that their capital ratio would not fall below 4.5% under stress.

Chinese growth has stabilised. June quarter gross domestic product growth was unchanged at 6.7% annualised and, while June data showed that investment and imports slowed, growth in industrial production, retail sales, credit and money supply all came in better than expected and mostly picked up. Meanwhile, producer price deflation continues to recede, which is a good sign but consumer price index inflation remains very low (just 1.2% year-on-year for non-food inflation), indicating plenty of scope for ongoing policy stimulus. The Chinese property market recovery remains a positive for growth – with residential property prices up another 0.8% in June or 7.8% year-on-year. Meanwhile, the MNI China Business Sentiment index rose in July. Finally, the decision by the United Nations Permanent Court of Arbitration in favour of the Philippines in relation to disputed area in the South China Sea signals a step up in geopolitical risks in the region.

After much anticipation, towards the end of July Japan announced more monetary and fiscal stimulus. However, the Bank of Japan has underwhelmed with roughly just a doubling of its of exchange-traded fund buying program (to ¥6 trillion per annum) but no increase in its bond buying program or monetary base target and no further cut in interest rates, suggesting no real further easing of monetary policy. The focus now shifts to fiscal stimulus with Prime Minister Shinzo Abe announcing plans for a ¥28 trillion economic stimulus package. While this is a big number (6% of gross domestic product) much uncertainty remains around how much is real new stimulus and how many years it will be spread over. In terms of economic data, falling wages and a rising yen added to pressure on the Bank of Japan in the lead up to the central bank's 29 July meeting. Japan's manufacturing conditions purchasing managers' index showed a welcome improvement in July though it's still weak and although Japanese jobs data in June remained solid and industrial production rose, household spending remains very weak – deflation remains evident in a fall in the consumer price index of -0.4% year-on-year. Weak Japanese machine orders and wages growth highlight the pressure for further policy stimulus in Japan.

Australian economic data released in July was on the soft side with a fall in building approvals and slowing momentum in retail sales reported for May although ANZ job advertisement data still pointed to reasonable jobs growth. Consumer confidence fell in July, presumably in response to the messy Federal election result and concerns over the outcome of the UK's decision to leave the European Union. However the fall was only 3% and still leaves confidence at the high end of the range of the last few years. Business conditions in June (pre-election) were solid, home loans rose in May leaving in place just a moderately slowing trend, housing starts rose to a record in the March quarter and jobs growth continued in June. Finally, apart from continuing low consumer price inflation in the June quarter, producer price and import price inflation was also weak. Private sector credit data showed weak growth with growth in the stock of lending to property investors slowing. Although the Reserve Bank of Australia left the official cash rate unchanged at its July meeting, it cut the official cash rate by 25 basis points to 1.50% at its meeting on 2 August.

MARKETS REVIEW

As expected the US Federal Reserve is more upbeat about the US economy, seeing the near-term risks as having diminished but still seeing only gradual interest rate increases ahead. The US Federal Reserve is not going to do anything to knowingly put the global and US economies at risk given the fragile nature of growth and the fact that inflation remains low. After much anticipation Japan has announced more monetary and fiscal stimulus. However, the Bank of Japan underwhelmed with roughly just a doubling of its of exchange-traded fund buying program (to ¥6 trillion per annum) and no increase in its bond buying program or monetary base target and no further cut in interest rates, suggesting no real further easing of monetary policy. Finally, the results of the latest European large bank stress tests were better than expected with only one bank (Italy's Banca Monte dei Paschi di Siena) out of the 51 covered with a negative fully loaded common equity tier 1 (CET1) ratio in 2018 under the adverse scenario. The main focus was always on Italian banks, including Banca Monte dei Paschi di Siena which ended up announcing a comprehensive recapitalisation plan just prior to the results being released.

July was a good month for risk assets (shares and global credit spreads), driven higher by good global economic data, a reasonably solid start to the second quarter earnings season out of the US, talk of easier for longer monetary policy and, in Australia's case, a further rise in the iron ore price. Whilst global energy markets were weaker on the back of fears of a supply glut and subsequent falls in the oil price, July was essentially the bounce back from the Brexit news in June. In the US both investment grade and high yield spreads were squeezed to the tightest levels seen since at least mid-2015. The rally was driven by the record lows in government bond yields and the record highs in equity markets – both leading investors to look elsewhere for value. European investment grade outperformed its US counterpart, driven by the European Central Bank's corporate bond buying program while Asian investment grade performed in line with the US.

The Global Fixed Income team's blended credit spread, a barometer which measures global physical credit spread movements, was 13 basis points tighter over the month, led by European and high yield as the main outperformers, followed by the US, whilst Australian investment grade spreads were marginally tighter. The Australian investment grade market was two basis points tighter over the month. Global high yield spreads were 52 basis points tighter, offsetting some of June's underperformance.

CONTACT DETAILS

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