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

AMP CAPITAL

Global Fixed Income Perspective

Prepared by Simon Warner

JUNE 2015

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 19 years' investment experience together with a wealth of knowledge in macro markets, credit markets, commercial lending and protected growth.

Portfolio strategy and outlook

Currently, two major events are hitting markets coincidentally. We believe that the events in China are more significant than those in Greece.

We have long thought that the Greek fiscal position is hopeless without a write-down. This belief remains central to our analysis of the news flow. We were taken by surprise by the referendum announcement but not by the result. Indeed, a straw poll on the desk gave the uniform response that if we were voting, we would have all voted 'No'. This is because the Greeks are in an impossible position. They have a choice between the scary prospect of the huge dislocation and misery of leaving the euro, or the rolling recession and inevitable social decay that the creditors' insistence on austerity will bring.

It is with this frame of reference that we are waiting for the results of the latest round of negotiations. If they result in a deal with more austerity and no debt relief (the most likely scenario at the time of writing) then we will get a relief rally but the crisis will roll on. The vote last weekend marked an end to the public's tolerance for endless recession. There are many treaty and political hurdles to debt relief but ultimately the Greeks need roughly a 50% write-down to attain debt sustainability.

Having said all that, Greece is mostly headline risk with the underlying economic impact small. China on the other hand has the potential to be more serious, especially for Australia.

I think that policy responses to the share market weakness will be enough to stabilise the market. I also think it's not really the point. The point is that China is changing its growth model. This is a process that is welcome and inevitable but also one that is risky. As the economy rotates from manufacturing and investment towards services and consumption, growth will naturally slow. Given the run-up in asset prices and the rise in debt over recent years, it is possible that asset quality will deteriorate and this may hamper lending. A credit crunch is plausible. That is why asset price falls are worrying.

It is also why the Chinese authorities have acted so decisively. The good news is that they have plenty of room on monetary policy (including foreign exchange reserves) to support the market and the economy's transition. However, the glory days for Australian terms of trade are over and this will be an ongoing challenge for growth, the Reserve Bank of Australia (RBA) and the Australian dollar.

It is in these complex and volatile times that I feel most privileged to work at AMP Capital. The breadth of the firm and the access to specialist information doesn't make my job easy, but it does make me much better informed than others who are trying to make sense of things via only headlines and public research.

We have low risk on. We have hedged most of our credit. We will lift hedges if spreads move a little wider. We are very slightly underweight duration. We will reassess if Australian 10-year bonds get to 2.75%, at which point we will consider selling a little more.

Movie of the month? Let's go for *A Beautiful Mind* (2001), Ron Howard's moving tribute to John Nash, the father of modern game theory. As we consider the Greek negotiations, let's remind ourselves that the Nash equilibrium is very different in a repeated game to a one-off!

Macroeconomic review

US economic data released in June was mostly indicative of continued growth. The US Federal Reserve (Fed) kept US interest rates steady during the month, with no specific guidance on the timing of the first interest rate rise. Fed chair Dr Janet Yellen emphasised that "too much attention is placed on the timing of the first increase" and more importance should be on the “entire trajectory of expected policy”.

In Europe the main focus over the month was on Greece’s debt crisis which intensified with the increasing prospect of a debt default and exit from the euro. Towards the end of the month, the Greek Prime Minister announced a referendum to vote on the “creditor’s proposals”. However, the European Union and the International Monetary Fund consider that the debt agreement expired on 30 June 2015. The European Central Bank has placed a cap on liquidity funding to Greek banks. Despite Greece’s woes, the central bank was optimistic on European economic growth in June, forecasting European real gross domestic product annual growth at 1.5% in 2015.

China saw continued softness in data released in June. Structural headwinds remain a significant challenge and China will likely need to undertake further stimulus measures to stabilise growth in the short term. However, there are signs that the property market is stabilising in response to previous stimulus measures; this reduces downside risks. During the month the People’s Bank of China announced a cut to the benchmark lending rate by 25 basis points to 4.85% and lowered the reserve requirement ratio for some lenders.

In Australia economic data was mixed in June. Economic growth rebounded in Q1 2015, but this was due to stronger exports and inventories while business investment fell. Australia's real economic growth for the past year is still “below average” at a modest 2.3%. The RBA held the official cash interest rate steady at 2.0% in June. The RBA Governor gave a speech towards month-end in which he noted that the central bank is “open to the possibility of further policy easing, if that is, on balance, beneficial for sustainable growth.”

Markets review

June began with a sell-off of global bonds. This was led by German bonds which sold off over 50 basis points in the first two weeks of the month. The ongoing and tense negotiations between Greece and the Eurozone introduced significant volatility into bond markets. Australian bond yields rose in line with global counterparts. For the month overall, Australian three-year bonds rose to 2.10%, five-year yields rose to 2.32%, and ten-year bond yields rose to 3.06%.

The Global Fixed Income team’s blended credit spread, a barometer which measures global physical credit spread movements, was 11 basis point wider over the month. The Australian component performed better than the US and European investment grade markets, with the latter seeing credit spreads widen markedly. The US high yield market outperformed its European equivalent which was impacted by negative sentiment surrounding Greece during the month.

Important note: While every care has been taken in the preparation of this document, AMP Capital Investors Limited (ABN 59 001 777 591, AFSL 232497) and AMP Capital Funds Management Limited (ABN 15 159 557 721, AFSL 426455) make no representations or warranties as to the accuracy or completeness of any statement in it including, without limitation, any forecasts. Past performance is not a reliable indicator of future performance. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. An investor should, before making any investment decisions, consider the appropriateness of the information in this document, and seek professional advice, having regard to the investor's objectives, financial situation and needs. This document is solely for the use of the party to whom it is provided.