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AMP CAPITAL

Global Fixed Income Perspective

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Ilan Dekell, Head of Macro, offers his global view of Fixed Income markets, and insights into AMP Capital's portfolio positioning. Ilan is responsible for managing AMP Capital's active macro management investment processes in interest rate, currency, yield curve and relative value strategies across multi-billion dollar assets and portfolios.

Portfolio strategy and outlook

In Australia, we have become more constructive than we have been for a number of years. This is not to say that the structural issues that the Australian economy faces have dissipated. Major trading partners, particularly China, are facing their own structural issues. Australian mining investment will continue to fall rapidly over the next few years.

From our perspective, one of the best ways to measure the transition from mining to the non-mining sectors of the economy is through jobs growth. One of the key areas for this to impact the economy is through employment and wages. While wages will continue to be under pressure as higher wage jobs in mining are replaced with lower paid jobs elsewhere within the economy, the stability in the unemployment rate for the past six months is encouraging. With two further interest rate cuts delivered in February and now May, a weaker Australian dollar that now sits at fair value, as well as better atmospherics around the government budget delivered in May, we expect the Reserve Bank of Australia to remain on hold into the end of 2015.

While we still expect Australian bonds to outperform US bonds, the case to do so is not as strong as it was, and we would prefer to express these views in the shorter end of the yield curve where near-term central bank expectations have a greater bearing on price movements.

Globally, the pressure for higher global yields has continued in May. This initial phase of the bond sell off has been led by the long end of yield curve, suggestive that there has been a repricing of inflation risk, as we have previously discussed. Elsewhere, simultaneously, we are also seeing pricing of other interest rate sensitive assets also adjusting their pricing. While it's clear that higher interest rates are helping to drive this adjustment, it seems that there are other related factors that are also leading to these price adjustments. Regulatory shifts in global banking have reduced the ability for bank balance sheets to provide liquidity through market-making functions. A typical risk-reward framework informs that that higher volatility requires greater reward. The liquidity risk and the expectation of volatility directly related to this require a repricing of assets after many years where liquidity has been abundant.

For yields to push higher from these levels we expect further improvement in global economic data, driven by stronger consumption and investment than is currently apparent. We continue to look for a mid-year recovery in global consumption that can drive yields higher and an expectation that the US Federal Reserve can start to lift interest rates as soon as September 2015.

The ongoing risk of a Greek default also preoccupies us, with markets that are already susceptible to a liquidity shock looking shaky. It is with this in mind that buying credit protection is the best way to protect our credit exposure within the portfolios against these dual risks of higher interest rates and a disorderly Greek default.

What movie can I loosely associate with Greece? The Coen brothers' adaptation of Homer's ancient Greek poem Odyssey, *O Brother, Where Art Though*?" of course. The line-up includes George Clooney, John Goodman, Holly Hunter, John Turturro and Charles Durning. Ulysses (Clooney) escapes from jail to find previously-hidden cash from an armed robbery. Along the way they come across many challenges and with bizarre luck they come out of it all pardoned and unscathed. Let's hope Greece can do the same.

Macroeconomic review

Economic data in the US was mixed in May, although there were some healthy signs that the US economy should recover. During the month the Q1 2015 real gross domestic product result was revised down, primarily due to the cold winter weather, the strong US dollar negatively impacting exports, and the slump in oil prices undermining energy investment. The US Federal Reserve maintained existing monetary policy, mainly due to the strength in the US dollar which has impacted the outlook for US growth. The US Federal Reserve indicated optimism that "following the slowdown in Q1 2015, real economic activity would resume expansion at a moderate pace". However, a June interest rate rise was considered “unlikely”. The first interest rate tightening would be decided “on a meeting-by-meeting basis”.

Europe’s economic recovery appeared to gain traction in May. The region achieved solid economic growth in Q1 2015. However, activity was inconsistent across the European continent. Concerns over Greece’s ability to repay its creditors remained a consistent headline with no real resolution reached by month-end. The worries are ongoing with International Monetary Fund maturities looming, raising the question about whether Greece will be able to fulfil its debt obligations. In the UK the general election saw the Conservative Government returned to power with a surprising majority.

The slowdown in China’s economy continued in May. Activity data including industrial production, retail sales and fixed-asset investment was broadly weaker during the month. In an effort to support the economy, the People’s Bank of China cut the benchmark lending rate by 25 basis points to 5.10%. The move followed comments in the bank’s quarterly monetary policy statement that there remains a lot of downward pressure and the People’s Bank of China will walk a 'fine line' in its easing process. Further easing measures are expected.

In Australia economic data released in May was lacklustre. During the month the Reserve Bank of Australia made a further mild downgrade to Australia’s gross domestic product growth and inflation forecasts. The Reserve Bank of Australia therefore appears to now have a neutral stance on monetary policy, implying no immediate prospect for a further interest rate cut. The Deputy Governor also gave a speech in which he highlighted the challenging transition after the mining investment boom. He mentioned that the central bank’s interest rate cuts are seeking to “strike a prudent balance – to help encourage consumption growth and thus business investment, but avoid the type of imbalances that could cause problems later on.”

Markets review

The month of May began with a continuation of the aggressive sell-off in global bonds seen in late April. US 10-year bond yields moved to a high 2.34% before finishing the month at 2.16%. While this was due to a combination of factors such as the stabilisation in the US dollar and the oil price and a recovery in inflation expectations, the substantial long positioning in the German bond market exacerbated the move.

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