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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

As has been the case with increasing frequency over recent months, China remained the focus of market participants in August. We have been looking for signs of a cyclical bounce. However, in an environment of a potential structural decline in gross domestic product, there is little evidence of a trough. There has been only a marginal improvement in financial conditions, despite an easing of policy through various channels. Among emerging market economies, many other countries in addition to China are exhibiting signs of stress, including Brazil, South Africa, Turkey and Malaysia, just to name a few. While these may all seem like idiosyncratic stories, what many of these countries have in common is the large increase in US dollar-denominated debt, particularly by corporates. Many emerging market economies have benefited from the commodity super cycle of the past 15 years, either directly or indirectly, as commodity producers, beneficiaries of sovereign oil producing investment or through heavy industry capital goods demand. This super cycle has recently rolled over due to the broad-based decline in commodities. This has seen emerging market economies come under stress, which could be exacerbated by a higher US dollar and higher US interest rates.

It isn't all doom and gloom out there though. The US economy has been benefiting from a household sector that has performed well at an aggregate level, while at the same time benefiting from aggregate real income growth and positive wealth effects. With the US economy growing above potential gross domestic product over the past few years, the tightening of labour market capacity is clear. The UK, and even Europe in recent times, is experiencing similar cyclical upturns. It is against this backdrop that the US Federal Reserve will determine whether to raise rates in September for the first time since 2006. While I fear that global growth will remain constrained in the years ahead, I personally believe that the US Federal Reserve should hike rates. This will allow for a better-functioning financial system, and offset the moral hazard that exists within the global economy, irrespective of ones view on inflation. There are certainly risks associated with this strategy that could lead to unintended consequences, particularly due to poorer liquidity conditions within financial markets. However, a focus on the trajectory of yields rather than a 0.25% increase in the policy rate should ultimately lead to fundamentals dominating investor behaviour.

For our portfolios, we continue to run very low risk, with much of our credit risk hedged, and we are modestly overweight duration. We will look for further volatility in markets in the months ahead to provide greater opportunities in duration and credit. The risk/reward at current levels is not attractive enough to add risk. With the arm wrestle between emerging market and developed market economies, at this juncture, we prefer to express the bulk of our global macro risk through relative value trades favouring economic underperformance in Asian and commodity-producing economies versus the US. We are expressing these views through both currency and interest rate spreads.

What movie best describes the situation in China, where policy makers are trying to learn how the economy and financial markets will react as they rebalance the economy and undertake structural reform? I cannot go past *Groundhog Day* (1993), where Phil (Bill Murray), wakes up every day stuck in a loop, every day repeating itself, trying different approaches to ultimately win the affection of Rita (Andie MacDowell). At first he has no success, but with every day repeated, he learns from his mistakes and improves himself, eventually achieving success. Let's hope that China's success comes quicker than the 10,000 years the writer of Groundhog Day said Phil was stuck in his loop.

Macroeconomic review

US data releases were mostly strong in August, despite increased global market turbulence. The meeting minutes from the US Federal Reserve's July meeting indicated that the central bank appears to be "approaching that point" of raising interest rates. However, the minutes also suggested that the US Federal Reserve Committee needs to see "some further improvement" in the labour market before raising interest rates.

In Europe, an agreement at the start of the month between the Greek Government and Eurozone finance ministers saw Greece secure another bailout. Greek Prime Minister Tsipras subsequently resigned and called for elections to be held on 20 September amid disagreement within his own party over the bailout conditions. Progress in the situation was nonetheless well received. Data released over the month was good. The European economy achieved positive quarterly growth in Q2 2015. However, activity growth remained patchy across the European continent.

During the month the People's Bank of China decided to devalue the yuan which led to increased market volatility. Concerns were compounded by a range of weak data releases which hinted at an economic slowdown in China. By the end of the month the yuan fell to its lowest level against the US dollar since mid-2012. Concerns about a possible currency war subsequently emerged, as fears increased that other governments might decide to respond with their own devaluations in order to boost their exports.

Australian economic data was mixed. The Reserve Bank of Australia lowered its 2016 growth forecast, mainly due to lower population growth, a delayed "pick-up in non-mining investment from 2016-17" and lower government spending. Inflation pressures, as measured by the TD Melbourne Institute inflation gauge remained modest in August, despite a falling Australian dollar. In terms of activity, the National Australia Bank business survey recorded softer results for July, but remained more optimistic than the consumer sentiment survey. Australia's labour market data continued to puzzle with strong jobs growth in July, but the unemployment rate rising to 6.3%. Positively though, nominal wage pressures remained modest in Q2 2015 and were consistent with mild inflation.

Markets review

August began with a continuation of the grinding rally in bonds seen in July. Late in the month, however, due to a combination of poor share market sentiment and further risks surrounding China and commodities, market volatility increased substantially. In the US, however, economic data continued to be robust and even accelerated in some sectors. This led the US Federal Reserve to adjust its rhetoric more towards monetary policy tightening. In Australia, bond yields moved slightly lower in line with global bonds, but spent most of the month in a fairly tight range. The yield curve in Australia flattened throughout most of the month before steepening aggressively at month-end. This was mainly due to a move higher in global yields in combination with renewed expectations of further monetary easing by the Reserve Bank of Australia.

Credit and equity markets got off to a good start in August as Greece's sovereign debt crisis abated. As the month progressed, however, volatility increased due to a deterioration in sentiment regarding China's growth. Credit spreads widened for the month overall, although this was largely driven by macroeconomic conditions and increased volatility in global equity markets. The Global Fixed Income team's blended credit spread, a barometer which measures global physical credit spread movements, was eleven basis points wider over the month. The Australian component outperformed its US and European equivalents, despite the China-related weakness seen during the month.