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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 we start 2016, investors' focus continues to be locked on China and oil. China, through the devaluation of its currency, is creating financial market instability as China's debt deflation is exported to the rest of the globe. The news flow of global economic data is underwhelming but by no means catastrophic; but in a world where growth continues to face structural headwinds, due to high levels of debt and ageing demographics in key economies, it is easy to understand why we are seeing market volatility.

The commodity super cycle that was led by China has truly rolled over. Capital expenditure, employment and income related to these sectors are continuing to fall globally. For commodity producing economies that have relied on China, this casts a long shadow on future growth, pushing beyond the commodity-related sectors directly to negatively impact nominal incomes and government fiscal balances.

Commodities, and in particular oil, also impact inflation heavily, which in a world where debt is high, can become a nasty cocktail. Low inflation makes it much harder to grow your debt away through high nominal growth, and at the same time liabilities become larger as yields fall. However there are positives to the commodities weakness as well. Cheaper commodities reduce costs for consumers. This is widespread, from filling up the car to jumping on a plane, to the cost of Tupperware. A lower currency in commodity producing countries also helps their tourism sector. And through these dynamics, service sectors of the economy benefit.

It is somewhere between these two influences that the future lies. We are watching the consumer and employment closely to see if the decline in the industrial sectors will broaden out and weigh further on growth. Ongoing volatility and falls in wealth will weaken confidence and the willingness to consume and invest. Inflation can rise on base effects alone if oil and other commodities simply stop going down, but this alone will not repair fiscal balances or improve the profitability of resources companies.

Through this lens, it highlights the importance of active management and thoughtful portfolio construction. Both of these can cushion returns, providing a better risk/return portfolio particularly in tail events, leaving investors in a position to take advantage of the value opportunities created when volatility hits.

In regards to positioning, we maintain moderate exposure to credit as valuations remain attractive, although we continue to run hedges on a portion of this risk, awaiting better opportunities. We continue to favour long duration exposure in commodity-producing countries, including Australia, Canada, and New Zealand, as well as Asian economies such as Thailand and Korea, with partial offsetting risk in the US and Hong Kong. We have also favoured similar strategies in currencies, being short the commodity-producing currencies as well as Asian currencies and the British pound whilst owning the US dollar and Japanese yen, which continue to be attractive in our view.

For our Australian risk focused portfolios we have been building long duration positions as valuations have become more attractive. We believe the pressure remains for the Reserve Bank of Australia to cut interest rates further in 2016, after we felt they would be on hold for the second half of 2015. In Australia, consumption has been steady, and this is with the backdrop of improving employment and lower petrol prices. The consumer has drawn down on savings in the past 18 months further supported by positive wealth effects. The question we ask ourselves is "will the consumer continue to drawdown on savings in an environment where wealth effects fade?" As the pressure on lower nominal aggregate income continues, as the impact of a lower terms of trade continues to pass through the economy, and the risk of further capital expenditure cuts flows through, we think the consumer and employment are at risk.

Macroeconomic review

US economic data remains mostly positive and as a result the US Federal Reserve's interest rate hike was not a surprise. There were healthy gains in both jobs and retail sales and wages growth is continuing to trend up. While durable goods orders were on the soft side and existing home sales fell, consumer spending was solid, consumer confidence edged higher, new home sales rose and September quarter gross domestic product growth was stable at 2% annualised. Meanwhile, inflation remains at 1.3% year-on-year, well below the US Federal Reserve's 2% target. A sharp fall in the ISM manufacturing conditions index was disappointing and highlights the pressure the US manufacturing sector is facing from the rise in the US dollar, however, the Markit manufacturing conditions index is holding up and services sector conditions indexes remain strong, although they have slowed a bit. There were weak readings for manufacturing conditions in the New York and Philadelphia regions and a slight fall in the National Association of Home Builders' conditions index but very strong gains in housing starts and permits, strong leading indicators and a larger than expected fall in jobless claims.

In the Eurozone, data remains soft although there were some positive surprises. Eurozone unemployment fell slightly but only to a still high 10.7%, highlighting the extent of spare capacity in the Eurozone economy. This, along with a fall in core inflation, supports the case for the European Central Bank's additional monetary easing. However, industrial production rose more than expected and while the business conditions purchasing managers' index slipped, its continued strength points to improved growth ahead.

Chinese economic data shows signs of stabilisation while Japanese economic data was mixed. Chinese property prices rose, indicating that the property market recovery is continuing. Industrial production rebounded and retail spending accelerated. China's inflation remains mild leaving room for China's central bank to cut interest rates further. There are still signs of weakness with manufacturing conditions indices providing mixed signals but essentially remaining soft. Services conditions indices remain reasonable. All in all, China appears to be progressively slowing down to a more modest economic growth pace in 2016. Japan's economic data was revised up, such that the recession in the third quarter disappeared – Japan's economy expanded by 0.3%, leaving annual growth at 1.6%. Japanese economic data was mixed with disappointing household spending and a slight rise in unemployment, but gains in the jobs-to-applicants ratio and housing starts and a rise in core inflation to 0.9% year-on-year. The Bank of Japan enhanced its quantitative easing program to buy longer dated bonds and expand the purchase of exchange traded funds but it was a small move relative to the size of the current program.

Australian economic data continues to be mixed. The rebound in September quarter gross domestic product growth indicates the economy is continuing to find ways to fill the gap left by mining investment. However, the October trade balance is showing a renewed deterioration and domestic demand remains weak. Retail sales growth was solid albeit at odds with a marginal slip in consumer confidence. Jobs growth surged in November with the unemployment rate falling to 5.8%. A rise in skilled vacancies provides further evidence that the labour market is strengthening. Offsetting this is the general slowdown in the housing sector and inflation remains weak. December saw the iron ore price continue to fall, reaching a new eight-year low of US$40 per tonne. This means an ongoing loss of national income and a further blow-out in the budget deficit. This was confirmed by the Mid-Year Economic and Fiscal Outlook which projects the four year deficit outlook to be a cumulative A$26 billion worse than projected due to a combination of weaker commodity prices and lower economic growth. This pushes out the return to surplus by another year to 2020-2021. The Reserve Bank of Australia remains reasonably positive but retains a mild easing bias.

Markets review

Global bond yields were fairly flat during December. US bond yields finished the month slightly higher. There was turbulence in the US high yield market with some US mutual funds freezing redemptions in junk bond investments. On the whole, US corporate health is good and some of the funds affected had very concentrated investments in risky and illiquid bonds. Eurozone bond yields rose early in the month as a result of the European Central Bank's smaller than expected increase in its quantitative easing program. In Australia, the fall in commodity prices continues to put downward pressure on bond yields.

As expected the US Federal Open Market Committee raised interest rates for the first time since 2006. Credit markets were still weaker overall, despite lower supply and reduced activity, however there was a modest rebound from the earlier weakness intra-month. Commodity prices continue to weaken with the plunge in the oil price putting pressure not only on equity investors but also on investors in energy debt with some US mutual funds freezing redemptions in these investments. Idiosyncratic risks are still prevalent but macro themes continue to dominate investor sentiment.

Credit spreads tightened slightly over the month however the materials sector was a notable underperformer, impacted by the slump in commodities. Issuance was light in advance of what is typically a busy start to the new year. Technicals were mostly unchanged although liquidity was light, in line with normal seasonal dynamics.

The Global Fixed Income team's blended credit spread, a barometer which measures global physical credit spread movements, was fifteen basis points wider over the month. Investment grade markets outperformed high yield markets which continue to remain under pressure. The Australian investment grade market widened by ten basis points, while the US and European investment grade markets were seven and five basis points wider, respectively. Global high yield spreads were 69 basis points wider, driven again primarily by weakness in the US high yield market and linkages to oil and commodity markets.