AMP Capital Investors Limited
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Global Fixed Income Perspective

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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

I recently visited a cheese factory near Parma in Italy and marvelled at the centuries old process of making Parmesan. The process is scientific, highly organised and surprisingly manual. I was impressed by the consistency of a product that seemed to rely a great deal on the judgement of one person in the factory. The only discernible piece of technology was a thermometer! At AMP Capital we have built an approach that seeks to de-emphasise the role of any individual as much as possible and instead develop a process of fact collecting, analysis and signal generation that is as objective as possible. We still believe that we need master cheesemakers but I don't want them spending most of their time stirring curds and whey.

Japan has been on my mind recently and is a country that I think is under appreciated as a potential driver of markets over the rest of 2016. Japan has been a laboratory experiment for policy makers for two decades now. Japan was the first major economy to confront deflation, the first to cut rates to zero, the first to engage in quantitative easing, the first to think about coordinating elements of policy to fight deflation and one of the first to push rates negative.

Steve Hannaford in our Hong Kong office recently did some excellent analysis on the impact of negative rates in Japan on inflation expectations and the implications for the future in Japan. He found that negative rates from the Bank of Japan (BoJ) led to a substantial fall in long term inflation expectations. This raised real rates in Japan which strengthened the Japanese yen and undid much of the easing of financial conditions that took place under the first phase of "Abenomics". Our hypothesis is that the reason for this fall in inflation expectations was that the market inferred from negative rates that the BoJ is reaching the limits of possible policy. I believe this to be wrong and think that over the next few months the BoJ and the Japanese government will engage in a renewed effort to stimulate inflation expectations.

The way that this could happen is debt-financed fiscal policy, commonly known as "helicopter money". Abenomics coordinated fiscal and monetary policy but maintained a separation; the next step would be to formally bring the two arms of cyclical policy together. This would represent a significant shift in thinking and should raise inflation expectations. This combined policy is extremely powerful and could have unintended consequences. It seems likely that break-even inflation will rise and the yen will weaken but the second order effects are hard to forecast. I am making a case here that Japan is insufficiently analysed by most market participants and should demand more time. Events there could have significant consequences on markets over the rest of 2016.

Movie of the month has to be Japanese. I could make a great case for any Kurosawa but I suspect you will have seen many of them. Instead I'll venture two very different recommendations. Tokyo Story (Ozu 1953) is beautifully shot and its tales of intergenerational tension resonate today (it's also on Qantas this month!). Alternatively Sonatine (Kitano 1993) has yakuza, a beguiling soundtrack and some hilarious practical jokes.

Macroeconomic review

The US economy has experienced another weak start to the year, with March quarter gross domestic product up just 0.5%, annualised. However, weak March quarter growth has been the norm since the global financial crisis, with average growth of 1% annualised ahead of a rebound to an average 3% growth in the June quarter. So far the evidence is mixed though as to whether growth in the current quarter is rebounding. US economic data was otherwise strong. The trade deficit expanded in February, but job openings, new hires and the 'quit rate' (a guide to worker confidence in the job market) remain strong, jobless claims remain low and the Institute for Supply Management's non-manufacturing conditions index improved in March. Retail sales were softer than expected in March but previous months were revised up so this is not so bad. Industrial production fell more than expected in March but manufacturing conditions improved in the New York region, small business confidence fell and inflation readings were weaker than expected. US housing data was mixed with falls in starts and permits but solid readings for home builder conditions and existing home sales. Finally, US first quarter earnings have seen some mixed results for high profile technology stocks but have generally been better than expected.

In Europe, it was no surprise after its huge effort in March, to see the European Central Bank on hold at its latest meeting, with President Mario Draghi indicating the bank remains ready to do more if needed. Meanwhile, the European Central Bank's bank lending survey revealed solid growth in loan demand and the composite business conditions purchasing managers' index for April remained solid. Economic data was mixed, with weak German factory orders and a fall in the services conditions purchasing managers' index in March. However, the level of the services conditions purchasing managers' index still remains consistent with moderate growth. Unemployment fell again in February, albeit the level remains high. There was an acceleration in March quarter gross domestic product growth and a tick up in bank lending and economic sentiment – both of which are consistent with ongoing growth. A fall in core inflation to just 0.8% year-on-year is likely to keep the European Central Bank's policy very accommodative.

In China, economic data continues to suggest that growth is stabilising and possibly improving, however it is too soon to tell if the upswing will be sustained. Chinese gross domestic product growth for the March quarter slowed, as expected, to 6.7% per annum, reflecting the weak start to the year. However, the list of data showing stabilisation or improvement in March expanded further to include the purchasing managers' index, producer price inflation, exports, imports, electricity consumption, railway freight traffic, industrial production, retail sales, fixed asset investment and total financing. The bottom line is that the incremental stimulus measures of the last year or so are now helping growth. In addition, the worst could be over for Chinese capital outflows. Chinese foreign exchange reserves rose in March for the first time in five months. After adjusting for valuation effects, the pace of decline in reserves has slowed to US$42 billion in March from US$142 billion in December, suggesting capital outflows are slowing. China's Caixin services conditions index improved in March adding to confidence that growth momentum improved. Chinese property prices also continued to increase in March, led by Tier 1 cities. While this is consistent with other indicators of improved growth in China, it also warns of renewed measures to slow property bubble fears in some Chinese cities.

In Japan, the major news was the decision by the Bank of Japan not to undertake more monetary easing despite soft economic data, inflation readings being well below target, ongoing strength in the Japanese yen and the Kumamoto earthquakes mid-month. Japanese economic data was mostly soft with strong labour market readings (although this may be due partly to a declining labour force) and a rebound in industrial production but a dip in inflation back into negative territory, a fall in core inflation to just 0.7% year-on-year, poor household spending and a fall in small business confidence. Japan's manufacturing purchasing managers' index fell further to a weak reading of 48, possibly impacted by the recent earthquake.

Australian economic data was mixed with lower than expected March quarter inflation data the main news item. The consumer price index fell by 0.2% quarter-on-quarter leaving inflation up just 1.3% year-on-year, its lowest annual increase since the third quarter of 2009. Other data released was mixed: building approvals bounced 3.1% in February but this followed a 6.6% decline in January, retail sales were weaker than expected in February and look to have lost momentum, the trade deficit widened in February and services and construction conditions purchasing managers' indices softened in March in contrast to manufacturing sector strength. In addition, consumer confidence fell again in April to be well below its long-term average and skilled vacancies fell in March for the second month in a row suggesting jobs growth may start to slow. On the positive side, there were solid gains in housing finance in February for both owner occupiers and investors, a surge in business conditions to an eight-year high and stronger business confidence according the National Australia Bank's business survey. Better than expected jobs growth pushed the unemployment rate down to 5.7% in March.

Markets review

Following significant action by many central banks during March, April was relatively quiet. After a nervous start which saw bond yields fall, the 'risk on' environment returned and global government bond yields generally rose slightly for the remainder of the month. The yield curve steepened as long-end yields crept higher. The US Federal Reserve's meeting minutes revealed nothing new, reiterating its data-dependent stance on interest rate hikes. The European Central Bank and Bank of Japan implemented no further accommodative measures and the market is not expecting additional near-term Chinese monetary stimulus. Global sentiment remains uncertain and volatile and can move swiftly from a 'risk on' to 'risk off' bias in the current market. In Australia, the Reserve Bank of Australia left interest rates on hold at its April meeting, but expressed discomfort at the rise in the value of the Australian dollar. The Reserve Bank of Australia subsequently cut interest rates by 0.25% to 1.75% at its meeting on 3 May.

Following significant action by many central banks during March, April was relatively quiet. However the tailwinds persisted, supporting risk assets. The US Federal Reserve's meeting minutes revealed nothing new, reiterating its data-dependant stance on interest rate hikes. The Bank of Japan surprised markets with no further accommodative measures and the market is not expecting additional near-term Chinese monetary stimulus. The European Central Bank provided some more detail on the Corporate Sector Purchase Programme and left participants guessing on how much crowding out would occur and potential spill-overs across credit quality and different regions.

The strong commodity price rebound – particularly in oil with West Texas Intermediate up 20% – alongside a fall in the US dollar was also a key driver of credit market spread tightening. This translated heavily through mining, materials and energy high yield as well as equities, providing broad-based support for other related sectors that had been under pressure in recent months.

The Global Fixed Income team's blended credit spread, a barometer which measures global physical credit spread movements, was 15 basis points tighter over the month, led by moves across most regions and in particular the higher beta segments such as high yield. The Australian investment grade market was 12 basis points tighter on the month. Global high yield spreads were 70 basis points tighter, continuing their strong performance since the mid-February wide point in spreads.