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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

The global economy and bond markets are at an extremely interesting juncture. Most observers still refer to the 'recovery' in the US but with the unemployment rate close to cyclical lows and wage pressure slowly growing, it hardly seems like the right term. Europe is in 'recovery' but it is a fragile one with many of the structural issues around growth and the sustainability of the Eurozone still unaddressed. China is in the midst of a structural slowdown with a long-term challenge to rebalance to a sustainable economic model. This period of rebalancing is fraught with danger. Japan meanwhile is still stuck with a persistent deflationary mindset.

Headline inflation is very low everywhere but core measures are closer to averages. Some economies like the US look close to capacity but the ongoing commodity oversupply and deflationary forces from emerging markets make widespread inflation pressure feel unlikely. Real growth is sluggish too and this low nominal growth world puts pressure on high nominal debt loads.

Meanwhile, credit markets are full of powerful but conflicting forces too. Valuation is more attractive than a few months ago and policy is still supportive, but the risk of commodity-related default is real and disruption is challenging many established business models. We are fortunate in these parts of the cycle to have such a well-resourced and credentialed credit research team. We deeply believe in the value of fundamental credit research and this point in the cycle is where name selection is most critical.

These cross currents are hard to navigate and as ever in these instances we rely on our investment process. In credit we had hedged the bulk of our aggregate risk in Q2 2015. As spreads have widened we lifted these hedges. Our portfolios have benefited as a result of these hedges but have not been immune from name-specific risk and more commodity exposure than would have been ideal. I see value in credit spreads at these levels and we are overweight.

On duration the story is tough. Australia is in the middle of the emerging markets / commodity turbulence and I still expect the Reserve Bank of Australia will have to provide further support to the economy next year. Valuation is more favourable to that view now with about half a rate cut priced into the front end of the curve. However, the global duration outlook is less clear with base effects due to unwind from headline inflation in coming months. This is likely to see deflationary risk unwound which will out pressure on long end yields to rise.

I prefer to be positioned in Australia through a spread trade: long the middle part of the Australian curve where hikes are priced in, and short the same part of other global curves.

We continue to relentlessly improve our investment process and we have recently introduced a new tool to help us track single name credit spreads. We are also continuing our investment in quantitative research. One goal for these improvements is to make our process even more transparent and allow our clients to see all the way through our process in real time. This greater transparency will allow clients to understand the drivers of our performance in greater detail and our customers will be able to use our underlying analysis themselves. Please let me know if you would like a demonstration of our prototype.

I am an unashamed James Bond fan. I have seen Spectre (2015) twice now and thought it started brilliantly but slid from there. I would be delighted to discuss more in detail in person! I am also including a trivial James Bond research note this month. I hope you enjoy it on the bus or at the weekend. If you are not a fan then you should spend 10 minutes elsewhere!

Macroeconomic review

US economic data weakened in October. US economic growth slowed in Q3 2015, although this was mostly reflective of a falling inventory contribution. American price pressures were also sedate in September given weak commodity prices and a strong US dollar. Yet core inflation is still running at a decent pace. Economic activity readings were concerning. The US Federal Reserve held off raising interest rates in October due to concerns that weaker global growth would impact the US. Yet the meeting minutes indicated that “many” on the US Federal Reserve committee expected that US labour market and inflation conditions would be “met later this year”, allowing the central bank to begin raising interest rates.

In the Eurozone data was mixed. In particular, the region struggled with subdued inflation as price pressures remained sedate, largely reflecting the sharp decline in commodity prices over the past year. In terms of policy, during the month the European Central Bank indicated that further monetary stimulus will be debated at the next December meeting. Another stimulus package could include more bond purchases and a cut to the already negative deposit rate. The European Central Bank President highlighted that “concerns over growth prospects in emerging markets” and the “developments in financial and commodity markets” continue to “signal downside risks to the outlook for (European) growth and inflation”.

Chinese data generally continued to weaken over the month, although there were some signs of stabilisation. China reported slightly slower gross domestic product growth of 6.9% in Q3 2015, which was just below the official target for 2015 of 7%. In an effort to counter short-term and structural headwinds to growth, during the month the People’s Bank of China cut interest rates by 0.25% and the required reserve ratio by 0.5%. Further additional easing measures are also expected. China also announced the approval of its 13th Five Year Plan, a key detail of which was the transition from the one-child policy to a two-child limit.

Australian economic data released in October mostly met expectations. Australia recorded modest inflation in Q3 2015, likely due to subdued economic growth, sedate wage pressures and weak commodity prices. Australia’s annual inflation rate is now running at 1.5%, while underlying inflation is running at 2.2%, indicating very little price pressure. The Reserve Bank of Australia held the official cash interest rate steady at 2.00% with no specific forward guidance on monetary policy. The meeting minutes suggested that the central bank is taking comfort that lower interest rates and the weaker Australian dollar are supporting economic activity.

Markets review

Global government bond yields were mixed in October, with most activity seen in the second half of the month. After a slow start due to disappointing economic data releases, US bond yields finished October higher on increased speculation that the US Federal Reserve will move to tighten monetary policy at its December meeting. Meanwhile, Japanese and Eurozone bond yields fell in anticipation of further quantitative easing. Australian bond yields were little changed during the month, supported mostly by the low consumer price index reading for Q3 2015.

In October, investor sentiment in credit and equity markets improved and volatility subsided, particularly in the second half of the month as idiosyncratic risk receded. Credit spreads were generally tighter across developed markets, but did not retrace the widening seen in September. While liquidity conditions improved with a more balanced mix of buyers and sellers, volumes proved to be inconsistent and unpredictable.

The Global Fixed Income team’s blended credit spread, a barometer which measures global physical credit spread movements, was nine basis points tighter over the month. The Australian component underperformed, widening by seven basis points, while the US and European investment grade markets were 15 basis points tighter. Global high yield spreads were 68 basis points tighter.