AMP Capital Investors Limited
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GLOBAL FIXED INCOME PERSPECTIVE

MARCH 2017

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 20 years' investment experience together with a wealth of knowledge in macro markets, credit markets, commercial lending and protected growth.

PORTFOLIO STRATEGY AND OUTLOOK

It has been a while since I last wrote an update. I apologise for the delay between communications.

It's been a busy few months for fixed income markets so I will give a perspective on our views about duration and credit spreads, an update on positioning and performance and how we are thinking about the next few months.

There has been a significant rise in government bond yields in the last few months. In recent weeks this rise has abated and we are currently retracing some of the move. Our indicator-set picked up acceleration in the global economy in the period before the US election and we think that the bulk of the move in US rates since November is reflecting those fundamental forces.

The move has been exaggerated by an expectation of short-term growth friendly policies from President Trump and we believe that these expectations are being unwound in the face of the new administration's seeming failure to be able to get anything done.

We were short duration in the months around New Year but are now square. We will go short again if yields continue their correction lower, due to our base-case view that the US economy will perform reasonably well this year.

In Australia we are more conflicted. The economy is still weak and it is likely that house prices will ease in coming months as supply comes online. This will reduce the wealth effects that have been supporting the consumer. Business investment is still anaemic so there appears to be limited support to GDP in the second half of the year. The base case is that the RBA will be on hold, with a risk of more easing at some point. We will buy bonds if rate hikes start to get priced in.

Credit spreads are quite a bit narrower than this time last year. Our view is that they no longer offer much potential for meaningful further compression. However, the default outlook is low so credit still offers an attractive premium. As a result of this changed regime we are now positioned in more liquid, higher-rated and shorter tenor credit securities. We are therefore able to sell down our holdings if there are signs of defaults or add to risk if we get an opportunistic widening.

Look out for a series of more thematic fixed income research from AMP Capital in coming months. We are working hard on getting clearer about risk premiums and inefficiencies in fixed income. We are aiming to be explicit about our view on risk premiums, their attractiveness and the best way to access them. This will allow us to be more transparent about portfolio risk and the rationale underpinning our risk positions; and we hope, make our performance both better and also easier to predict.

My break from regular updates reminds me of waiting for much of my young adult life for a new Stanley Kubrick film. I was 12 when Full Metal Jacket (1987) was released and only learnt of Stanley's incomparable oeuvre in my later teens. I become obsessed with The Killing (1956), Paths of Glory (1957) and Barry Lyndon (1975). I have never walked into a cinema more excited than to see Eyes Wide Shut (1999); and I have never walked out more crest-fallen. Die Another Day (Tamahori, 2002) is a close second!

I hope this update did not leave you similarly disheartened. I will be more regular in coming months.

MACROECONOMIC REVIEW

As widely factored into global markets, the US Federal Reserve raised interest rates by 25 basis points for the second time in three months, lifting the target range to 0.75% to 1.00%. However it continued to manage expectations, reiterating in its policy statement that further increases are likely to remain gradual. The Trump administration's tax reduction and fiscal stimulatory policies continued to have a steadying influence on markets during most of the month, following a broadly well-received address to Congress in late February. However, towards the end of the month, the withdrawal of the Affordable Care Act repeal bill focussed the market on the sharp reality that political intentions do not always translate into implementation. It should also be noted that, in the US, Congress is the dominant controller of the budget and will ultimately decide what compromises it will be prepared to settle on. However this will likely be balanced by the administration's push to implement a smaller government agenda and therefore the failure to repeal or amend the act is likely only to distract in the short term. During the month the Trump administration formally approved the Keystone XL pipeline, acting on his commitment to infrastructure spending.

In Asia, latest figures showed Japanese industrial production fell in January and the March manufacturing conditions purchasing managers index slipped a little, but is still on a rising trend. Chinese manufacturing conditions improved in February and services conditions remained strong, consistent with growth remaining solid. The National People's Congress kept economic targets in line with expectations, with growth at 6.50% and inflation at 3.00%

In Europe, Eurozone economic confidence rose to a new six-year high, adding to the message from business conditions purchasing managers indices that growth is likely to accelerate. The euro also exhibited support as immediate deflationary threats appear to have passed, suggesting an earlier than expected end to the Eurozone's loose monetary policy and bond-purchasing programme.

Oil experienced a new bout of volatility, falling sharply as US inventories increased. This produced fresh worries about a potential glut in the commodity which had a flow-on effect to energy stocks. Adding to the uncertain backdrop, Saudi Arabia's oil minister, Khalid al-Falih, said that the Organization of the Petroleum Exporting Countries' output reducing deal could allow shale producers to increase production which could potentially affect the stability of the crude oil price if supply increased significantly.

On the geo-political front, Geert Wilders' failure to make the predicted significant inroads in the Dutch election gave further support to the euro and provided some relief ahead of the more important French presidential elections. In the UK, Article 50 was triggered, formally initiating the exit process from the European Union. Uncertainty and stability concerns in Europe are likely to remain throughout 2017.

In Australia, figures from the Australian Bureau of Statistics showed further acceleration in the property market, with Sydney and Melbourne exhibiting the most aggressive rises. Countering these concerns, Australian population growth showed a robust 1.5% year-on-year increase, which is supportive of property demand. However, the apparent unconstrained growth is of concern to the Reserve Bank of Australia, which stated during the month that "'there had been a build-up of risks associated with the housing market". Indeed, at the end of March, the Australian Prudential Regulation Authority announced further tightened mortgage rules, including stricter limits on interest-only lending. Despite the property market backdrop, underlying economic conditions, including banks raising rates out of cycle and a strengthening Australian dollar, mean there is less likelihood of an imminent interest rate rise by the Reserve Bank of Australia.

MARKETS REVIEW

Credit markets in March were characterised by divergent spread movements across regions, with tightening seen in Australia and Europe and modest widening observed in the US. The general theme however remains one of continued above-trend macroeconomic data in Europe and the US, which has resulted in an environment of persistently low volatility, which has allowed credit markets to continue to perform well.

The main news over the month surrounded President Trump's inability to gain sufficient support from within his party to pursue his proposed repeal of the Affordable Healthcare Act. This has cast further doubt over his ability to achieve his outlined tax reform plan, and has somewhat dampened the positive sentiment in risk markets, which have performed extremely well since November on the back of anticipated policy changes in these areas. Against this backdrop, the March batch of US economic data releases was generally favourable, highlighted by further gains in employment numbers and housing starts.

The Global Fixed Income team's blended credit spread, a barometer which measures global physical credit spread movements relative to government bonds, was in aggregate unchanged over the month. Spreads on US investment grade corporate issues tightened by three basis points and Australian spreads moved five basis points tighter. Global high yield market spreads were 25 basis points wider over the month, partially retracing their recent strong performance.

CONTACT DETAILS

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