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AMP CAPITAL

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

Bond markets are on the move. We flagged last month that the recent period of stability in bond markets was likely coming to an end and that turned out to be true. What has happened? How are we positioned for these moves and what is our plan?

The key change in the last few weeks has been an ebbing of the forces that pushed yields down so aggressively in Q4 2014. Commodities and the dollar have stabilised and this has helped stabilise short-term inflation expectations. Action by the European Central Bank has become fully priced by the market and economic data in Europe is pretty good. Easing in China has lessened concerns about the short-term growth picture there too. These factors have caused yields to unwind some of the Q4 2014 rally.

We have been short duration but yields are now at our early targets. Our medium-term fair value for US 10-year yields is 2.50-2.75%, but without a meaningful uptick in the activity data we think some support will be at 2.25%. We have rotated our short position from the long end of the yield curve to the short end and replaced some of the exposure with options. This is because so far the sell-off has been driven by the long end and has steepened the curve. From here any further rise in yields will require stronger activity data and that is likely to pressure front-end central bank pricing.

These changes have restructured our portfolios to continue to be protected from a further rise in yields but hold some gains in a retracement.

One of our core competitive advantages at AMP Capital is the breadth of the firm and the investment expertise that we have in all asset classes and jurisdictions. We meet regularly with our colleagues in equities, listed infrastructure and listed real estate. The message I am hearing from them is that they see relative value within their asset classes but that valuations are at risk from higher rates.

We have been on record for a long time about our concerns that investors who are focused on total returns will sell as rates rise and this will push spreads wider. The feedback from our equity teams has added to this concern. We believe that regulatory and technological forces have reduced market liquidity and increased the likelihood of price gaps and volatility.

We have therefore bought protection against a part of our credit portfolio. Importantly though, in the longer term any widening will be a buying opportunity as we still like corporate fundamentals and our analysts can find good value. This is not the end of the credit cycle because rates are rising due to lower deflationary risk and better activity. In the short term, however, we expect technical forces to dominate. We will lift hedges and add credit on any meaningful widening of spreads.

There has been a lot of news in the Australian banking sector this week. The equity price volatility is a warning against a pure equity approach to building an income portfolio. However, from a credit perspective, the news has been good. The profile of earnings is unspectacular but solid and more capital is good for bond holders. Our banking analyst Linden Smith has a market perform rating on the senior debt of Australian banks.

How about a movie about recapitalisation? Casino Royale (2006) is the one. I love the titles, score, script, parkour, blue swimmers, Aston Martin DB5, blood crying, brother from Langley and Venice. Therefore just about all of it! I do especially like Eva Green's performance though. As she says: "I'm the money".

Macroeconomic review

US economic data disappointed in April, mostly due to harsh winter weather conditions and the strength of the dollar. Activity data released over the month still suggested that the US economy is running at a 2.5% growth pace, allowing for quarterly gross domestic product swings. The US Federal Reserve's meeting minutes for March suggested a wide spectrum of views for when US interest rates will rise. "Several participants" favoured June as a starting point. However "others" viewed that lower energy prices and the strong US dollar "would continue to weigh on inflation in the near term". This could allow the US Federal

Reserve to delay interest rate rises "until later in the year" or even "until 2016".

In Europe data was indicative of a steady improvement in economic conditions. The European Central Bank's more aggressive policy stance appears to be bearing results. The key interest rate stayed at 0.05% in April and monthly asset purchases remained at €60 billion. The European Central Bank expressed confidence that "there is clear evidence that monetary policy measures we have put in place are effective." Over the month uncertainty regarding the future outcome of Greece's bailout funding negotiations continued with no true improvement in the situation.

Chinese economic data continued to weaken. Deflationary pressures remained significant as a result of below-trend growth, the property market downturn, falling commodity prices and a strengthening Chinese yuan. The People's Bank of China announced a 100 basis point reduction in the required reserves ratio, a key policy tool and a strong signal that the authorities remain committed to supporting growth and addressing downside risks.

Economic data in Australia was better than expected. Inflation was mild in Q1 2015 with the headline consumer price index recording only a slight quarterly rise. The annual inflation rate is now running at only 1.3%, which is well below the Reserve Bank of Australia's 2-3% target range. Employment data was surprisingly robust, with solid job gains recorded for March. The Reserve Bank of Australia held the official cash interest rate steady at 2.25% in April, but lowered the rates to 2% in early May, judging that the Australian economy is "likely to be operating with a degree of spare capacity for some time yet. The central bank now has a neutral stance on monetary policy, implying no immediate prospect for a further interest rate cut.

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Markets review

Global bond yields were relatively stable in the first part of April as economic data proved uneventful. However, yields subsequently rose sharply in the latter part of the month. While softer economic data in the US had little impact on yields, the European Central Bank's quantitative easing program appeared to positively impact credit data, thus supporting the rise in yields. Furthermore, the stabilisation in the oil price has resulted in a partial unwinding of the aggressive downward repricing in inflation expectations that has been seen globally over the past several months.

The Global Fixed Income team's blended credit spread, a barometer which measures global physical credit spread movements, moved six basis points tighter over the month. The high yield component outperformed, while the Australian, US and European investment grade markets saw similar moderate tightening over the month.