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

## Portfolio strategy and outlook

We have been wrong on duration. Our process has been highlighting a stronger US economy and weaker economic conditions in Australia, China and Europe, and this has been correct. Based on the strength of the US recovery and the starting point for valuation, we had expected this activity pattern to lead to a modest rise in yields through 2014. We were wrong. Why? There are two key, somewhat related reasons.

Firstly, our models are picking up that global yields are a greater driver of US yields than has historically been the case. This in turn has pulled Australian yields down too. Essentially, the policy moves from Japan and Europe have dragged all yields down despite activity numbers in the US being ok. We misjudged this relationship.

Secondly, inflation pressure has fallen everywhere in the second half of 2014. This downdraft was taking place before the more recent fall in commodity prices that has further depressed headline inflation. This fall in inflation has reduced pressure on the likely early mover central banks (US Federal Reserve [Fed] and Bank of England) to raise rates, spurred further easing in the deflation-risk economies of Europe and Japan, and created leeway for the likes of the Reserve Bank of Australia (RBA) to cut if necessary. We observed this fall in inflation in our indicators but thought that activity data would be a bigger determinant on yields. We were wrong.

So what to do? We have altered our scorecards in recent weeks to reflect the more favourable economic environment for bonds. This means weighting the low inflation numbers more highly and the activity numbers less. This set up means that we will reinitiate a short duration position if the deflationary environment abates. When thinking about the likelihood of this it is important to form a view on whether inflation is falling due to persistent output gaps or due to one-off factors. To answer this we will be watching wage numbers very closely. In our assessment, the US has the least spare capacity so the least structural disinflation pressure. However, in the near term this is more likely to manifest itself in an ongoing US dollar rally. Ongoing slow growth outside of the US could keep global bonds yield very low for some time to come.

What movie for this story? *The Dam Busters* (1954). The music and finale are great but my enduring memory is of Michael Redgrave as designer Barnes Wallace, rolling up his trousers and walking in the sea, recovering parts of a failed test bomb so that he can figure out what went wrong and improve it. That's what we are doing with our duration positioning too!

## Macroeconomic review

US economic data released in December remained strong, with activity releases pointing to fairly robust growth. Employment data was also solid with non-farm payrolls increasing by much more than expected, and the two previous months were revised upwards. The Fed kept the policy interest rate on hold, noting that the US economy is "expanding at a moderate pace" with "solid job gains". Dr Janet Yellen commented that the Fed "considers it is unlikely" to raise US interest rates "for at least the next couple of meetings".

The Eurozone economy continued to struggle over the month. Softening activity data and the falling inflation trend in Europe add weight to the argument that the European Central Bank is likely to step up its monetary easing program. The central bank's December meeting only confirmed this, raising the prospects of quantitative easing as early as Q1 2015.

Data in China remained subdued, reflecting slowing growth due to the property downturn, anti-corruption campaign, as well as sluggish external demand. Annual growth is likely to come in around the low 7% mark, while 2015 may see slightly lower growth as the property downturn weighs on fixed asset investment and related downstream effects. At the same time, fiscal stimulus (infrastructure spending) will likely provide some offset.

The RBA left the cash rate on hold in December, completing a year where the cash rate remained steady at 2.50%. The RBA Board again stated that "the most prudent course is likely to be a period of stability in interest rates". However, expectations that the central bank could cut the cash rate grew during the month and the market began to price in greater risk of a rate cut during 2015. Data in Australia was mixed.

## Markets review

Global bond yields mostly fell in December, mainly due to softer economic data and a continuation of the fall in the oil price. These were compounded by a market environment with quite poor liquidity, particularly in the lead up to Christmas. US Treasury yields were relatively stable in December and underperformed other markets, largely due to strong US data and growing expectations that the Fed will lift the federal funds rate in 2015.

The Global Fixed Income team's blended credit spread, a barometer which measures global physical credit spread movements, was nine basis points wider over the month to 166 basis points, despite rallying eight basis points from the intra-month wides (around 16 December). The Australian component was two basis points wider. High yield underperformed significantly in the US and Europe, particularly around mid-month. US high yield ended approximately 46 basis points wider. European investment grade again outperformed the US largely on the back of central bank policy deviations and implicit support for risk assets.