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

Portfolio strategy and outlook

In the past few weeks we have built a short duration position across our funds. It remains to be seen if this is a tactical position or if our indicators point to the start of a larger move up in bond yields but we have seen enough to make us believe that rates will retrace some of last year's rally.

This judgement is based on the news that we have seen in the past month. The European economy is doing better. Economic data there has surprised to the upside and the regional business confidence numbers are turning up. We are firmly of the belief that Europe has significant long-term challenges that threaten the viability of the Eurozone. But for now the economy can do better thanks to low rates, a weaker euro, higher equity prices and lower oil.

A similar set of circumstances is presenting itself in Japan where a combination of a weaker currency, fiscal policy that is still supportive and lower energy prices that boost real incomes will support growth. Long-term issues remain in Japan, but the shorter-term outlook is quite bright.

We also see signs of an upturn in the US economy. Economic surprise indices have been soft recently but have now stabilised. The benefits of lower energy prices will flow through in coming months and the uptick in core services inflation is a tentative sign that the narrowing output gap is feeding through to pricing power.

The key area of uncertainty remains China. We know that overcapacity is still prevalent with weakness in profits, imports and price data showing that China continues to be a source of disinflation for the rest of the world. We see this force showing up in the goods prices component of consumer price indices elsewhere in the world too. The main uncertainty for us is the strength of these forces, not the direction.

Australia sits at the centre of these competing forces. The weakness in China is a major issue for Australia's terms of trade and the currency is not low enough yet to offset this impact. The Reserve Bank of Australia (RBA) has eased and may well ease again, but monetary policy has lost a lot of its impact in the last five years. It appears to us to be much easier to identify the direction of forces within Australia than assess the extent to which the cross currents of China, a developed world rebound and policy easing offset each other. Therefore, we will have to be very careful about the extent to which we reflect a global short duration position in our Australian only funds. A curve steepening position to reflect a view of higher global rates with domestic weakness has worked in the past and is something we are likely to use again.

AMP Capital takes its commitment to diversity and equal opportunity for women very seriously. In recognition of International Women's Day, we are recommending a feminist classic this month. *Woman of the Year* (1942) is a masterpiece and Katherine Hepburn is my favourite actress. She developed and sold the script and chose her own director and co-star. It was the start of her on-again, off-again screen relationship with Spencer Tracy. Hepburn plays a fiercely independent woman whose career as a journalist takes priority. It's a great movie and amazingly still feels contemporary today after more than 70 years.

Macroeconomic review

US economic activity was mixed in February. Investors remain cautious due to uncertainty regarding the timing of future monetary policy decisions by the US Federal Reserve (Fed) and how these might reverberate across some markets. The Fed's meeting minutes for January indicated a cautious and patient view on the timing of rate rises. Without providing a specific timetable for rate increases in 2015, Fed chair Janet Yellen indicated at month-end that the Fed "will want to feel confident that the recovery will continue and that inflation is moving up over time".

In the Eurozone, an improvement in some key data and the extension of debt negotiations in Greece led to improved sentiment over the month. Yet inflation remains subdued with consumer prices having declined 0.6% in the year to January.

In China a major development over the month was the People's Bank's decision to cut the required reserve ratio for banks and benchmark rates. The move was made amid ongoing concerns regarding inflation and lacklustre growth in China, and affirms a more aggressive easing stance with more easing measures likely to follow. Positively, Chinese activity data for February released in the latter part of the month started to turn.

In Australia, the labour market opened the year on a soft note with employment falling and the unemployment rate rising to a 12-year high of 6.4%. Business investment also fell, while activity data was more positive. The RBA cut the official cash interest rate to 2.25%, citing concerns regarding Australia's growth prospects, and downgraded its forecast for Australia's real gross domestic product growth for 2015 due to more modest consumption growth, a milder increase in liquid natural gas exports and a delay in the expected recovery in non-mining business investment.

Markets review

Global government bond yields were mostly unchanged in February. The exception was the US which saw yields rise due to solid economic data releases. The back-up in yields was largely driven by an abatement of the concerns seen in January. Yields over January had rallied to new lows, which was aggressive given that the Fed is likely to tighten monetary policy around mid-year. The move higher in yields over February unwound part of these aggressive moves. Economic data in Europe and Japan was positive and above expectations in February. This eased some of the buying pressure on bonds. Resolution around Greece also helped bond yields to sell off.

The Global Fixed Income team's blended credit spread, a barometer which measures global physical credit spread movements, was 14 basis points (bps) tighter over the month to 160 bps. The Australian component underperformed and was only two bps tighter, while the US was the outperformer in both investment grade and high yield. European credit spreads continue to be well supported by the European Central Bank's quantitative easing announcement in January.