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AMP CAPITAL

Global Fixed Income Perspective

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Ilan Dekell, Head of Macro, offers his global view of Fixed Income markets, and insights into AMP Capital's portfolio positioning. Ilan is responsible for managing AMP Capital's active macro management investment processes in interest rate, currency, yield curve and relative value strategies across multi-billion dollar assets and portfolios.

Portfolio strategy and outlook

In January deflationary risks continued to be priced into global bond yields. Equities and credit spreads have also been caught between the positive impact of further easing of financial conditions, and the negative impact of deflation feeding back into growth.

As we look through our indicators, we still find little proof that demographics have been the major cause of lower bond yields over the past 12 months. Instead, we continue to find strong relationships between a number of our cyclical indicators and bond yields. Along with a falling oil price and stronger US dollar, these relationships can provide a highly accurate explanation for the fall in bond yields over the past 12 months.

There is no doubt that supply and demand dynamics have supported these fundamentals. However, instead of supply and demand driving bond yields we would reinforce that fundamentals have driven demand and supply. A shift in inflation expectations will see these dynamics change.

It is through this lens that we can determine what is required to see bond yields push higher: oil price stability, US dollar stability - or at least a slower pace of appreciation - and positive broad-based global business activity momentum. If we see these factors occur, we will feel more comfortable that cyclical inflation will follow. In regards to structural inflation, there are large output gaps in parts of the global economy, including in China, Australia and Europe. Meanwhile, there are output gaps that have likely closed or are close to closing in countries such as the US, UK, New Zealand and Japan.

If the trends in global employment and household consumption data since 2013 continue - as we believe they will in 2015, supported by lower yields, easier monetary policy and lower oil and commodity prices - the risks of higher inflation driven by both cyclical and structural forces are under-priced. The biggest risk to this view is that the deflationary impact of China is much larger than we currently estimate.

In the short term, we may need to see the impact of oil prices flow through to the global economy before markets can focus on a broad-based turn in real manufacturing activity and closing output gaps rather than on the size of deflationary output gaps, supported by a stronger US dollar and weaker oil prices.

The conditions we would look for to position for higher yields are not currently in place. However, there are some early signs that we may be getting closer in the months ahead.

What movie best describes the process that we have gone through to ensure we are fully prepared for the months ahead? A remake of the 1960's Rat Pack movie *Ocean's Eleven* in 2001 starring George Clooney and Brad Pitt. Daniel Ocean (Clooney) hatches a plan to rob three casinos at once. The movie unfolds describing how each team member contributes to the final outcome, ensuring every possible risk is evaluated, and mitigated. It also highlights the importance of each member of the team's contribution. We will continue to evolve our process and use our indicators to determine key drivers of markets in the months ahead. It's rumoured that Frank Sinatra, who starred in the original, joked, "Forget the movie, let's pull the job!"

Macroeconomic review

US growth remained on track in January with real gross domestic product continuing to expand in Q4 2014. Both the manufacturing and the non-manufacturing Institute for Supply Management surveys for December also remained at levels signalling healthy growth. The US labour market ended 2014 on a robust note with strong job gains and the unemployment rate at a six-year low.

Economic conditions in the Eurozone continued to present significant challenges. A fall in the consumer price index showed that Europe slipped into mild deflation in January. Late in the month the European Central Bank finally announced its much–awaited quantitative easing program, citing "heightened risks" of prolonged "low inflation".

In China data confirmed the recent trend of stable but slowing gross domestic product growth in 2015 to the 6-7% range. China's official purchasing managers' index for December fell slightly to 50.1, while later in the month the HSBC flash manufacturing purchasing managers' index for January rose to 49.8, beating expectations but still below the 50 point level. China also reported softer inflation numbers, with consumer price inflation at multi-year lows, producer prices in deflation, and property prices continuing to decline.

Australian data was mixed. Inflation results were mixed for Q4 2014 with a subdued headline consumer price index, but a sharply higher underlying inflation measure. The National Australia Bank business survey showed sedate confidence and conditions readings for December. Employment data was surprisingly strong in December, suggesting that the labour market is starting to stabilise at the very least. However, Australia's unemployment rate remained elevated at 6.1% in December.

Markets review

Global government bond yields fell in January due to rising deflationary fears and various central bank moves, including the European Central Bank's highly-anticipated quantitative easing announcement, and the Swiss National Bank's unexpected move to abandon its exchange rate cap of 1.20 Swiss Francs per euro. The US Federal Open Market Committee's January statement also reflected increased wariness regarding deflation further to the fall in commodity prices. Australian three-year bonds fell to 1.95%, while five-year and ten-year yields also ended the month lower at 2.02% and 2.44% respectively.

The Global Fixed Income team's blended credit spread, a barometer which measures global physical credit spread movements, was eight basis points wider over the month to 174 basis points. The Australian component was four basis points wider. Investment grades spreads across Europe and the US both widened over the month, as did US high yield, while European high yield bucked the trend and finished modestly tighter, supported by the European Central Bank's quantitative easing announcement during the month.