AMP Capital Investors Limited
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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 19 years' investment experience together with a wealth of knowledge in macro markets, credit markets, commercial lending and protected growth.

Portfolio strategy and outlook

Fixed income and currency markets have settled into a range in the last month or so. The big moves in the US dollar and European fixed income appear to have exhausted themselves for now and the market is seeking new information to determine the next move. Our process uses valuation and the cycle as the primary determinants of asset price movements, and complements that with an assessment of technical and sentiment factors.

On valuation we still believe that globally bonds are expensive and credit spreads are close to fair value. The cycle is still unclear for duration with strong activity data (from a low base) in Europe being offset by soggy growth early in 2015 in the US. China is still weak and global price pressure is non-existent. There seems little reason to expect any major central bank to hike in coming months. The US will probably be the first to move, but so far the weather and the US dollar have caused growth to moderate and we are yet to see the positive impact from lower energy prices.

On credit, the decent economic backdrop and easy policy rates result in a low risk of a broad default cycle in the next year or two. Defaults are likely to be limited to the energy sector and marginal miners. However, an interesting development has taken place in our corporate health monitor. This signal is a composite of a number of company-level metrics that our credit team consistently considers including leverage, profitability and cash flow adequacy. This signal still says that corporate balance sheets are healthy but at the margin things are becoming a little less creditor-friendly. As we move into a point in the cycle where margins are under pressure, labour compensation will rise, mergers and acquisitions will be more common, and stock selection will become more important relative to the quantum of credit exposure.

All this should sound familiar to regular readers and leaves us still overweight credit, and close to neutral on duration. However, experience has made us worry about periods of consolidation presaging volatility. We are also always mindful of the potential for credit market liquidity to dry up in even moderate stress periods. In addition, the building negative correlation between equity markets and yields make us believe that a hiccup in rates will quickly cause gaps in other markets.

Therefore, we are preparing for a period of volatility. We are testing how our process will respond to various economic scenarios and how the portfolios we manage will perform. We have a set of trades and hedges that we will enact under various scenarios. We are watching, waiting and alert.

All this talk of liquidity conditions and how it can dry up when you most need it brings me to the great *Lawrence of Arabia* (1962). There are obviously lots of desert scenes with a lack of liquidity, but I particularly love the moment when an exhausted Lawrence and his companion stagger into the officers' bar in Cairo after the taking Aqaba. "We'd like two large glasses of lemonade please". I wonder how many holders of credit will be similarly desperate for liquidity in coming months.

Macroeconomic review

In March, mixed economic data in the US prompted the Federal Reserve (Fed) to recognise that "economic growth has moderated" and mildly downgrade its real gross domestic product growth forecasts for 2015 and 2016. Yet activity remained robust over the month, and employment data was also positive. In contrast, retail spending was surprisingly weak and housing starts data also disappointed, confirming the Fed's assessment that the US housing sector recovery "remains slow". In terms of policy, the Fed modified its commentary on US interest rates prospects at its March meeting, removing the guidance that policy will be "patient" on raising interest rates. However, Fed Chair Janet Yellen stated that this "doesn't mean we're going to be impatient".

The Eurozone's recovery appeared to gather pace in March. The European purchasing manager's index survey showed positive activity readings for the manufacturing sector, while industrial production data was less positive. The European

Central Bank (ECB) kept its key policy interest rate steady at 0.05% and maintained its commitment to expand the balance sheet through asset purchases. ECB President Mario Draghi was optimistic on European prospects with the central bank forecasting 1.5% real gross domestic product growth for 2015.

In China, data remained weak over the month, supporting the case for further monetary and fiscal policy accommodation. Activity data for January and February was generally below expectations, and the flash purchasing managers' index for March also disappointed. Elsewhere in Asia, while Japan's economy emerged from recession in Q4 2014, the strength of the recovery was downgraded during the month in a revised estimate.

Australian economic growth remained modest in Q4 2014. Labour market conditions improved in February with the unemployment rate edging down to 6.3%. The Reserve Bank of Australia (RBA) held the official cash interest rate steady at 2.25% at March's meeting, but signalled the possibility of a further interest rate cut by stating that "a further easing of policy may be appropriate over the period ahead". RBA Assistant Governor Guy Debelle considered during the month that global bond yields "term premia" have become "unusually compressed and there is little overall compensation for risk". Notably, Australian sovereign bond yields have declined "despite an increase in supply" with Australia's debt outstanding "considerably less" than other countries.

Markets review

Global bond yields rose in the first part of March amid improving economic data and positive sentiment relating to the global growth outlook and stability in the oil price. Yields reached their peak mid-month on the back of a solid non-farm payrolls report in the US, which showed another month of above-consensus jobs growth and reinforced the theme of a rapidly tightening labour market. For the rest of the month, however, bond markets fell back due to a combination of: softer economic data in the US; a dovish Fed meeting, which involved a downward revision to estimates of the Fed funds rate; and strong demand for bonds in Europe on the back of the ECB's quantitative easing program.

The Global Fixed Income team's blended credit spread, a barometer which measures global physical credit spread movements, widened over March. The Australian component outperformed, while US and European investment grade markets saw credit spreads widen over the month. High yield markets across the US and Europe also underperformed.

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