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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

If you have been following our updates in recent months you will be able to detect a line of thought about perceived versus actual reality. We have been wrestling all year with whether our framework for thinking about the relationship between the economy and the market is the correct way to think about the world. We feel that we have called the economy very well. In the Global Fixed Income team we have had a long-held view that the Australian economy would be weak and that the currency would fall. We have been right on both counts and recent days have seen economic consensus move our way.

We have also consistently been of the view that the US is on a solid recovery path but that Europe will likely struggle to stem deflationary forces. In addition, we feel that the insights of our Hong Kong team on China have also been accurate. Their report early in the year on the weakness of the property sector was particularly prescient. Our framework of translating economic insights into interest rate positioning has worked well in the past, but not so well in 2014. Is this a case of our perception of a reality being challenged? Or is this just one of those inevitable moments when our active investment process temporarily misfires?

I think that it would be remiss of us not to constantly question our approach and try to improve it. We recognise that our place in the financial market ecosystem places us in only an average position to assess flows and positioning. That is why our process has positioning as a complement to our analysis rather than the centrepiece. In a year when flow and positioning have been highly influential it is therefore our duty to search for new techniques to assess positioning and liquidity. We hope to roll these indicators out in coming months. In the meantime, our risk management processes are paramount. Clients rightly expect us to limit drawdowns and protect capital in all circumstances.

Finally, let me recommend a festive film in which these themes are to the fore. It is a philosophic treatise on the gap between perceived and true reality, a story of a man on a journey of discovery who opens the door of a new reality to all that he touches. I am of course referring to *Elf* (2003). So don't be a cotton-headed ninny muggins and watch it!

Macroeconomic review

US economic data released in November was solid. The Philadelphia Federal Reserve survey showed that manufacturing conditions rose to the highest reading since December 1993. Labour market data also showed solid job gains in October and the unemployment rate fell to a six-year low. The end of the US Federal Reserve's asset buying program over the month had minimal direct impact on markets.

In the Eurozone, growth concerns led to speculation of further stimulus by the European Central Bank (ECB). The European economy recorded mild 0.2% quarterly growth in Q3 2014. The headwinds of weak private bank lending, fiscal consolidation and a stronger euro earlier in 2014 appear to still be constraining the European economic recovery.

The People's Bank of China cut the benchmark lending rate by 40 basis points to 5.60% in November. The rate cut reflects the concerns the government has about weakening domestic growth. The move will provide some support to the economy alongside increased infrastructure investment and will likely be positive for Chinese equities. Chinese data was weak.

The Reserve Bank of Australia (RBA) held the official cash interest rate steady at 2.50%, recognising that the Australian dollar has "traded at lower levels recently". However, the central bank considered that the currency "remains above most estimates of its fundamental value, particularly given the further declines in key commodity prices in recent months". Australian economic data remained strong.

Markets review

Bond yields fell over the month as European growth concerns led to speculation of further stimulus by the ECB. Yields on Eurozone sovereign debt hit new all-time lows, while US Treasury yields fell from 2.31% to 2.16% due to changes in the oil price and growing deflationary fears in Europe.

Amidst overall mixed domestic economic data, and the RBA's continued maintenance of its monetary policy messaging, bond yields fell throughout the month, particularly at the shorter end of the yield curve. Australian three-year bonds fell 19 basis points to 2.37%. Five-year and 10-year yields also ended the month lower at 2.55% and 3.01% respectively.

The iTraxx Australia outperformed physical credit over the month, moving tighter despite the widening pressures seen in physical markets. Over the month, industrials outperformed financials. In terms of credit rating bands, BBB's underperformed as investors sold recent issuance in this space, while the A-rated band outperformed. By tenor, shorter-dated (up to three-year tenor) was the relative outperformer, with longer-dated tenors (seven-year to-ten-year) the underperformer.