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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

I love the films of Stanley Kubrick. I remember first watching *2001: A Space Odyssey* (1968) at home on a Sunday morning as a 13-year-old and being totally spellbound by the symmetric beauty of the photography, the eerie periods of near silence and the methodical pacing of the narrative. I also remember being completely blown away by the ending. I spent my first bonus on an original poster (which my wife doesn't let me display!) and I have read dozens of books on the film. I still can't tell you what it's about. Kubrick will always be my hero for never explaining it.

Financial markets often feel like the same kind of dense impenetrable riddle and certainly did at times during October! I am of course referring to the price action in US Treasuries on 15 October when we saw one of the 10 biggest moves since 2000 and the largest one-day move as a percentage of the starting yield in history. What made the day even more noteworthy was the lack of significant news to drive the market. Such events demand serious investigation and reflection. What drove the move? Why was it so severe? What can we learn for the future?

The most common explanation for the move is generally "positioning". It is indeed true that consensus (and AMP Capital) has been calling for higher US bond yields for some time now. This position is very expensive to hold given the steepness of the yield curve and the range trade we have seen this year has frustrated shorts. However, I think "positioning" is a trite explanation and there are at least three other factors that led to the extraordinary move.

Firstly, market participants have remarkably similar investment horizons nowadays. Even the stickiest capital demands consistent quarterly returns and monitoring is continuous. There are substantially fewer strategic risk takers now than in the past. Secondly, regulation has hampered the ability of banks to warehouse risk. Capital constraints and the lack of proprietary trading have limited the natural stabilisers that used to be a feature of the system. Thirdly, program trading is ubiquitous. Algorithmic price-making and the increase in electronic trading platforms are substantial innovations of the last 15 years, and have lowered the costs of transacting in all asset classes. The corollary of this has been increased concentration of price makers. Algorithms that are derived from similar data sets using similar statistical techniques are likely to be highly correlated.

These three factors are now established features of the market and investors should be mindful of their implications. For us they mean we need to continue to refine our stress and scenario testing, increasing our investment in analysing the technicals of the markets we trade in and reviewing what new regulations and market structures mean for liquidity premiums and fair values. More questions than answers, I know, but therein lies the beauty of seeking the meaning of life in modern fixed income markets.

Macroeconomic review

In October the US Federal Reserve announced the end of its quantitative easing program, noting that it "anticipates" that the current 0-0.25% policy interest rate will remain for a "considerable time" after quantitative easing ends. US labour market data was exceptionally strong over the month, with a 248,000 rise in payrolls and the unemployment rate falling its lowest level since July 2008.

The European Central Bank released the results of its stress tests of European banks which "identified capital shortfalls for 25 banks totalling €25 billion". However, this is mitigated by capital raised this year, leaving a €9.5 billion shortfall. A fallback in German data caused some concern over the month.

Chinese data was mostly positive, although property continued to be weak. China reported 7.3% real gross domestic product growth for Q3 2014, affirming the stable but slowing trajectory. The Bank of Japan surprised the market by expanding its asset purchase program to ¥80 trillion per year.

The Reserve Bank of Australia (RBA) kept the cash interest rate at 2.50%, but noted the "further pick-up in lending to investors in housing assets". Over the month RBA Deputy Governor Philip Lowe expressed concern that the current "highly stimulatory" global monetary policy settings could lead to "new financial vulnerabilities". Australian economic data was mixed.

Markets review

In the first half of October, bond yields fell back on global growth concerns, particularly regarding Europe. Yields in Europe and Japan were also impacted by further extraordinary easing measures. Risk aversion subsequently receded and yields sold off in the second half of the month, but still finished lower. Australian bond yields moved in line with global counterparts. 10-year yields fell 19 basis points (bps) while three-year yields fell 13 bps, leaving the three-year/10-year yield curve six bps steeper. US 10-year yields reached a 17-month low of 1.86% during an extraordinary trading session on 15 October amid severe weakness in equity markets. Yields subsequently backed up and ended the month 16 bps lower overall.

The iTraxx Australia marginally underperformed cash over the month, widening by eight bps. This was mainly due to a significant overhaul of the global credit derivatives market which saw the International Swaps & Derivatives Association release new definitions of credit default swaps (CDS). These now explicitly insure against debt write-downs, bond exchanges or conversions of debt into equity. Although index rolls took place in September, as a result of these new definitions, a number of on-the-run contracts did not trade until the start of October. This, along with increased risk aversion, led to underperformance in CDS.