insightpaper

GLOBAL FIXED INTEREST DEVELOPMENTS

APRIL 2016

INTRODUCTION

Within AMP Capital's global fixed interest process we try to identify inflexion points that support our valuations and investment hypotheses, so that we can position ahead of the market. While we have had a relatively pessimistic bias through the second half of 2015, we are starting to see some interesting shifts in our indicators and analysis that are worthwhile highlighting.

With an important week of data coming up, AMP Capital's Macro Global Fixed Income team highlights some key developments.

GLOBAL OUTLOOK

In theory, to see a sustainable push higher in risk assets, and see the Fed deliver the rate increases that they have forecast themselves to do, we need to see a synchronised growth uplift across regions. In this environment the policy divergence/strong USD regime can be offset with growth synchronisation/stronger high growth currency regime. And with the USD stable or only slowly appreciating on a broad-based basis, under this scenario, US yields can reprice to higher levels, without the feedback of a stronger US dollar (USD) into tighter global financial conditions. This, in turn, should be supportive for risk assets.

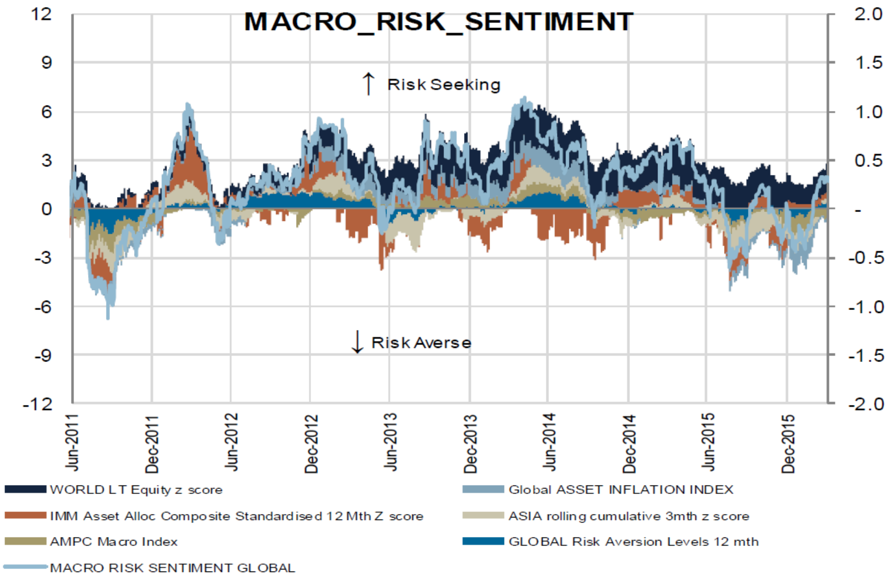
At first it was just the data surprising to the upside as market participants became overly bearish, but the data itself was not showing upside momentum. The chart which follows highlights the turn in data surprises in mid February.

GLOBAL ESI (DAILY)

Source: AMP Capital, Bloomberg

This allowed markets to reprice as the markets became too pessimistic in a short space of time. In the chart below note that the Global Macro Risk Sentiment Indicator pushed lower aggressively in the second half of 2015 and into 2016, with a strong recovery year-to-date.

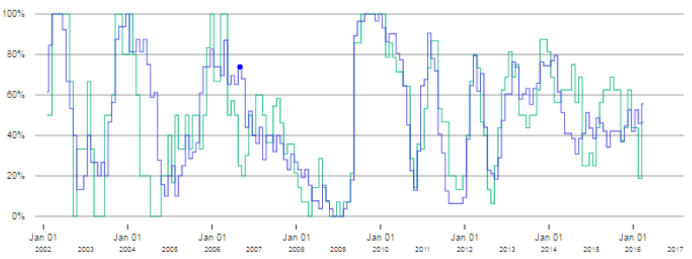
MACRO RISK SENTIMENT



Source: AMP Capital, Bloomberg

Both manufacturing and services Purchasing Managers Indices (PMIs) are bottoming with the improvement broadening out, importantly including China and the US.

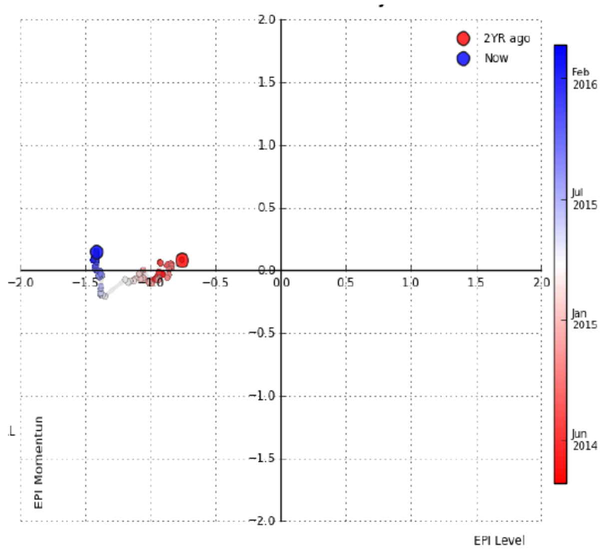
PMI BREADTH MODEL - 6M



Source: AMP Capital, Bloomberg

China's EPI (Economic Pressure Index) is starting to exhibit some upward momentum. Moving into the top left hand corner means that there is positive momentum but it is still a long way below historical trend growth.

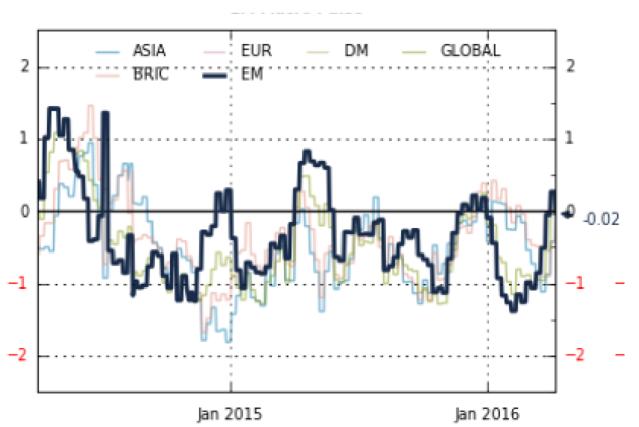
CHINA HEADLINE EPI HISTORY



Source: AMP Capital, Bloomberg

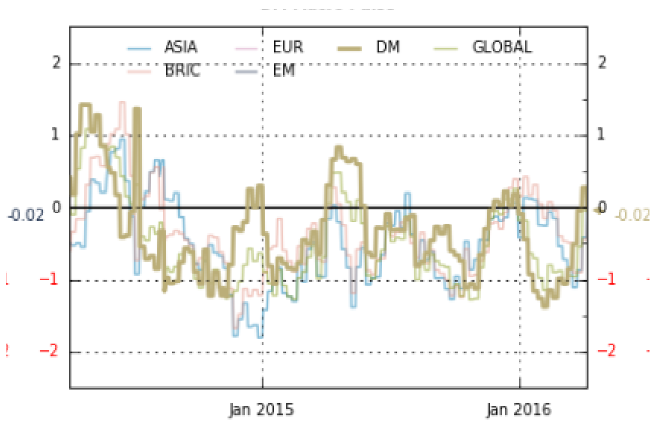
As we look across each region, the data is showing positive economic momentum, to support the surprise indicies momentum.

EM MACRO PULSE



Source: AMP Capital, Bloomberg

DM MACRO PULSE



Source: AMP Capital, Bloomberg

AMP Capital's Hong Kong office, which covers China, has noted some key leading components that may signify a turning point and have implications over the next three to six months.

We have already noted the PMIs in China, but there has also been an increase in projects approved by the central government, suggesting a boost to investment. These projects tend to have a two to three year duration.

CHINA PLANNED INVESTMENT FOR NEW PROJECTS YoY 3 month average

Source: AMP Capital, Bloomberg

The latest China GDP data uncovered the first improvement in China property investment. There still remains a large oversupply of both residential and commercial property, but there are some signs that there has been some improvement in the inventory overhang.

CHINA PROPERTY INVESTMENT YOY

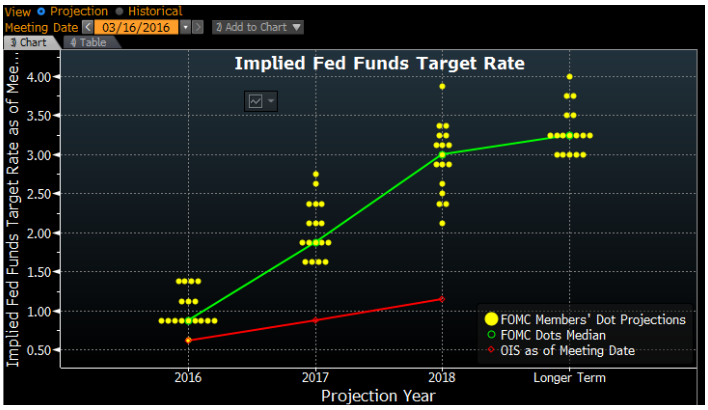
Source: AMP Capital, Bloomberg

Standard Chartered's China services tracker is also showing improvement, suggesting further improvement in the official data.

Altogether this suggests that we may be at a short term inflexion point, where risk assets can have another leg of performance supported by fundamental improvement. We don't believe the market is set up for a China recovery, and concerns remain on China's growth rate longer term as it continues to structurally rebalance its economy. However, the short term picture could lead to a reassessment of the outlook for 2016, and see further flow into risk assets, which is supportive for yields to push higher, particularly in the US.

Even if the Fed dots are overly ambitious, market pricing is a long way away from the dots. The red line below highlights market pricing of Federal Reserve interest rate policy.

IMPLIED FED FUNDS TARGET RATE

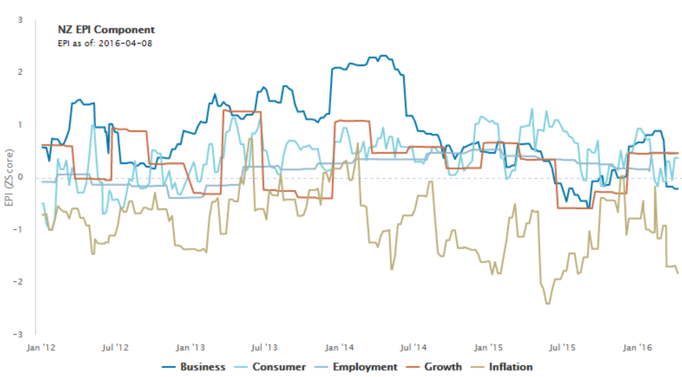


Source: Bloomberg

NEW ZEALAND OUTLOOK

Here in New Zealand we have a different perspective. Persistently low inflation and a softening business outlook on the back of the weakness in the dairy sector keeps the Reserve Bank of New Zealand (RBNZ) in play, and we expect more rate cuts to come in 2016. On the positive side, record net migration and tourism, coupled with solid construction activity, is supportive for consumers and employment. However, for the moment the Reserve Bank will be focusing on low inflation and will respond to that.

NZ EPI COMPONENT



AMP Capital, Bloomberg

Upcoming data in China and New Zealand will be key to gauging whether the short term shifts identified are noise or have genuine momentum to surprise markets further.

In New Zealand we have inflation data in the form of Q1 CPI. While this is backward looking, it will set the tone on whether the RBNZ will have to cut rates more aggressively than is currently priced.

In China, we await further data to allow us to determine whether the short term improvement in economic momentum can be sustained.

How the US dollar performs in this environment will also be important to monitor. If the US dollar rallies aggressively, or interest rates push aggressively higher, this will put the risk recovery at risk.

In our global macro portfolios, we are positioned for higher yields globally, New Zealand and Australian yields to fall versus US yields, and are considering positioning for a higher USD/JPY.

Note that we remain concerned about China on a medium to long term basis, and we don't expect an aggressive push higher in US yields.

WHAT DOES THIS MEAN FOR INVESTORS?

For our New Zealand portfolios we are currently long duration and are overweight shorter maturities, to benefit from more aggressive RBNZ easing than what is priced and the likelihood that the OCR will be on hold for an extended period following the cuts. We are also underweight longer maturities so will benefit from a steeper curve as improving global data puts upward pressure on global yields. Confirmation of the global themes above will see us increase our curve steepening exposure and reduce our long duration position back to neutral.

We also retain our overweight to inflation linked bonds which will perform in the period ahead as the RBNZ eases policy further, the NZD adjusts lower, and oil and other commodity prices stabilise. The stability in oil, on the back of the improving global outlook, will start to feed through into inflation over the medium term as historic falls in oil prices fall out of the calculation of CPI.

CONTACT US

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