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DIVERGING GLOBAL GROWTH:

An unlikely position of support for bond markets

May 2015

Global economies are increasingly out of sync with each other. On one hand, the US is considering interest rate rises off the back of a strengthening economy. On the other, Europe and Japan are continuing to implement quantitative easing policies to boost their lagging economies. While at first, this may appear to be challenging for global bonds, the policies have in fact supported markets and driven a fight for yield benefiting countries like Australia.

In this article, Simon Warner, Head of Global Fixed Income, AMP Capital considers the current environment globally and what this means for Australia. You can access AMP via the Advance Australian Fixed Interest Multi-Blend Fund, Advance Property Securities Multi-Blend Fund and the Advance Diversified Multi-Blend Funds.

Global policies across 2014 and 2015

2014 saw increasing economic divergence across the key developed markets around the world. Whether 2015 will see more consistency will depend on the effectiveness of monetary easing in Europe and Japan and the potential of rate rises in the US.

US

> The US Federal Reserve (Fed) ended its program of quantitative easing towards the end of 2014 due to signs of strength in the labour market.

> The Fed is expected to raise interest rates towards the end of 2015 despite benign wages growth and early signs that lower oil prices are placing downward pressure on core inflation.

Europe

> The European Central Bank (ECB) increased quantitative easing efforts in 2014 with interest rate cuts, a negative deposit rate and targeted longer-term refinancing operations (TLTRO) as a result of falling inflation expectations.

> The ECB has also recently announced plans to purchase €60 billion per month in bonds issued by Eurozone central governments, agencies and European institutions until at least September 2016 aimed at expanding the monetary base (money supply) in the Eurozone.

> It is anticipated that an expanded monetary base, lower yields and greater liquidity support for asset prices is likely to contribute to stronger credit and GDP growth.

Japan

> The Bank of Japan (BOJ) has been supplying loan funds to stimulate commercial banks' lending to the private sector and has committed to purchasing more shortand long-term government bonds.

> It voted to continue, these monetary measures will aim to increase the monetary base at an annual pace of ¥80 trillion in order to meet the BOJ's inflation target of 2.0%.

A rush to Australian yield

Australia continues to benefit from uncertainty overseas. Australian interest rates are higher than other developed economies, despite still being low and facing the prospect of further cuts. Concern over deflation and negative yields globally has meant Australia is viewed as a 'safe' high-yielding country compared to others and has resulted in increased investment demand for Australian bonds, particularly by older investors.

That said, this has driven up the price of Australian bonds, which means the returned yield for price is getting closer in line with those of low yield countries and is therefore becoming less attractive.

The outlook for bond yields

- Low oil prices and sluggish growth have continued to fuel concerns over deflation and have in turn kept global interest rates low. Ongoing central bank activity to manage this is likely to continue to support government bond markets in the short-term but will also see yields converge due to the rush to higher yield countries.
- In the medium to longer-term, assuming central bank activity is effective, a return to solid economic growth globally will mean bond yields gradually rise again.
- Australia's outlook is likely to be impacted by the weaker China market which Australia relies on, particularly for resources exports. The Reserve Bank of Australia is working to rebalance the Australian economy away from a reliance on mining investment and is likely to monitor the Chinese economy as part of interest rate decisions.

As a whole, bond markets have been supported by the environment of quantitative easing and falling commodity prices, with the outlook suggesting continued support going forward. Australian fixed interest assets continue to offer opportunities for investors globally with one of the higher official interest rates available.

Advance holds a higher allocation to Australian fixed interest in its portfolios than international based on the ongoing opportunities in this area and the potential risks of loss in international fixed interest once the US starts to increase rates. Advance also incorporated defensive shorter-term positioning in its Diversified portfolios through the Advance Defensive Yield Multi-Blend Fund last year to prepare for the prospect of rising interest rates globally.

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AD16195-0415jw