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Tuesday 24 – Thursday 26 August 2010 | Sydney

[Asset Allocation Masterclass]

Are bond yields the signposts for global economic growth?

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A sobering message

"Indeed, we have just entered Act II of the drama, when financial markets started losing confidence in the credibility of sovereign debt. …..

Doubts about sovereign credit are forcing reductions in budget deficits at a time when the banks and the economy may not be strong enough to permit the pursuit of fiscal rectitude,"

George Soros, June 2010

The story as we see it…

- Current macro climate is that of a two speed economy
- Managing risk in global fixed income has resulted in re-orientating exposures away from euro-periphery countries to larger G7 countries…however what's next?
- The direction of bond yields may provide the signpost to where global economic growth is really heading
- Active management is an important tool to assist in the preservation of investment exposures in fixed income

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Macro view relating to fixed income

Corporate bond primary market continues to see issuance

Sovereign debt crisis spreading from Emerging Europe to G7

Banks impacted by regulation and liquidity

High unemployment in Europe and the US

Removal of Government Guarantee

Fiscal stimulus receding

High yield mutual fund flows

Monetary policy tightening - interest rates rising

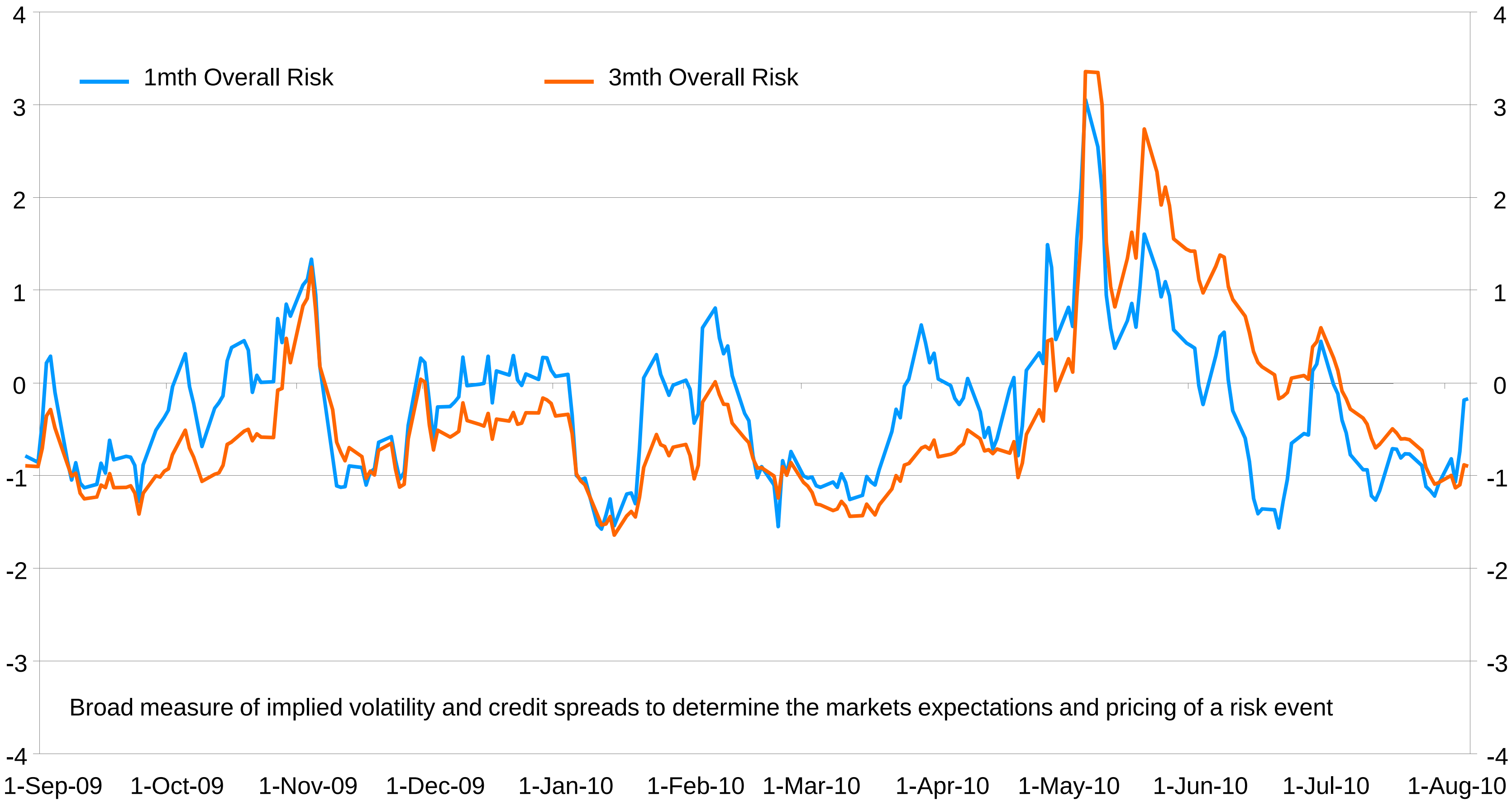
Who, where and when?

The mystery is who will buy $1.75 trillion worth of freshly printed US government bonds from 2010 onwards – to say nothing of the trillions of dollars worth to come in future years…..

A dramatic rise in the US personal savings could create a domestic appetite for bonds. However, a reversion to traditional American thrift would cause other headaches for policy makers desperate to rekindle consumption.

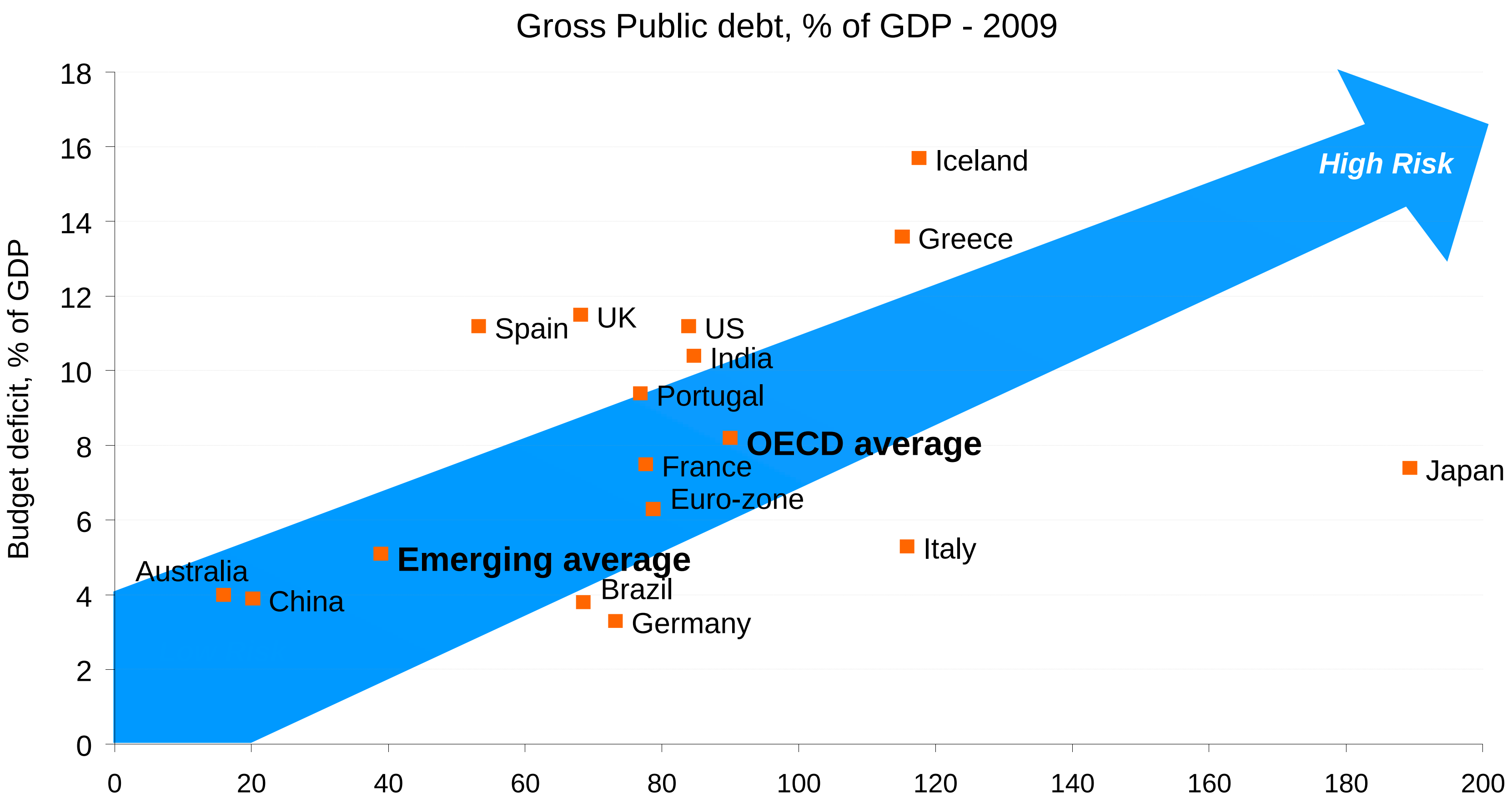
Prof. Niall Ferguson, Harvard Business Review 2009

What does our Risk Index suggest?



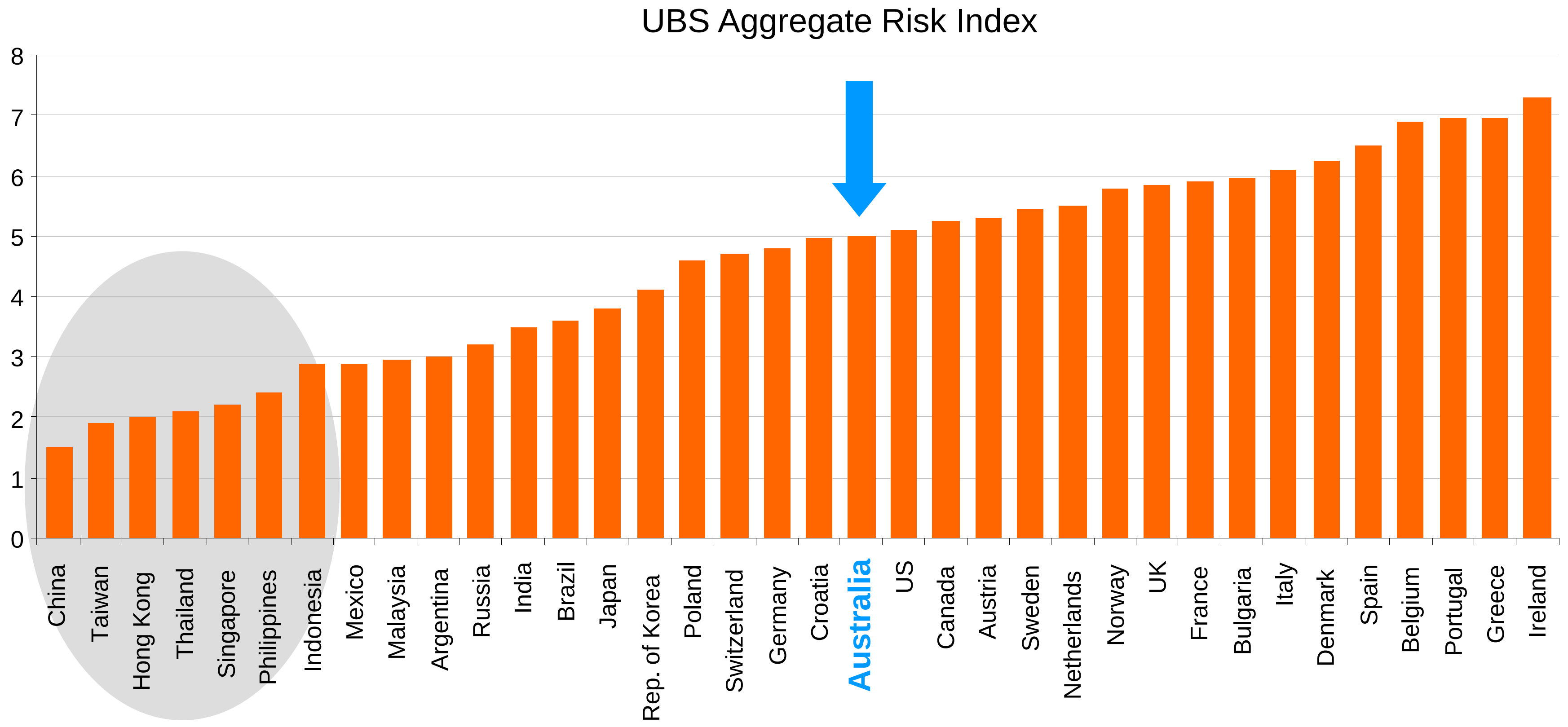
Source: AMP Capital Investors, Bloomberg
As at 6 August 2010

Relative public debt among selected countries



Source: OECD, International Monetary Fund (IMF), Eurostat, AMP Capital Investors, 2009

Asian countries have come out of the financial crisis in a much better fiscal shape than their Western counterparts

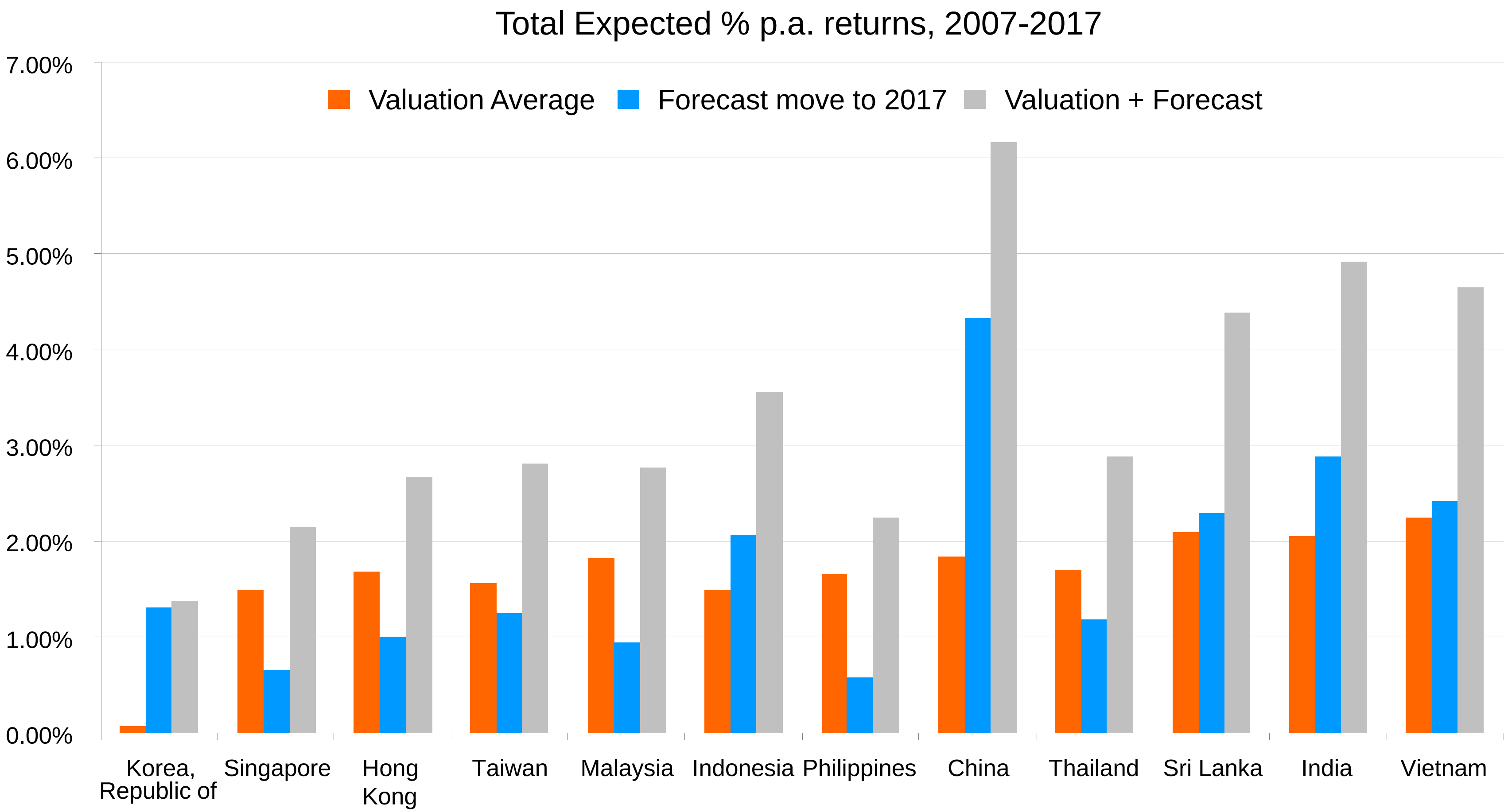


Total Risk Index, 2009

The indices are based on several indicators of domestic financial fragility including the domestic credit to GDP ratio, the banking sector's loan to deposit ratio along with the public sector debt to GDP ratio and several indicators of external fragility including the current account balance to GDP ratio, commodity export exposures, the external debt to GDP ratio, the export to GDP ratio and the FX reserve cover.

Source: UBS calculations, 2009

Relative appreciation of Asian currencies is expected to be between 1% and 6% p.a.



Source: AMP Capital Investors, IMF, June 2010

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Regulation – headwind or tailwind?

- Basel III and US regulations will require banks to:
  - Hold higher levels of capital and liquidity
  - Change business activities - move away from higher risk
  - Focus on longer term funding, away from short term deposits

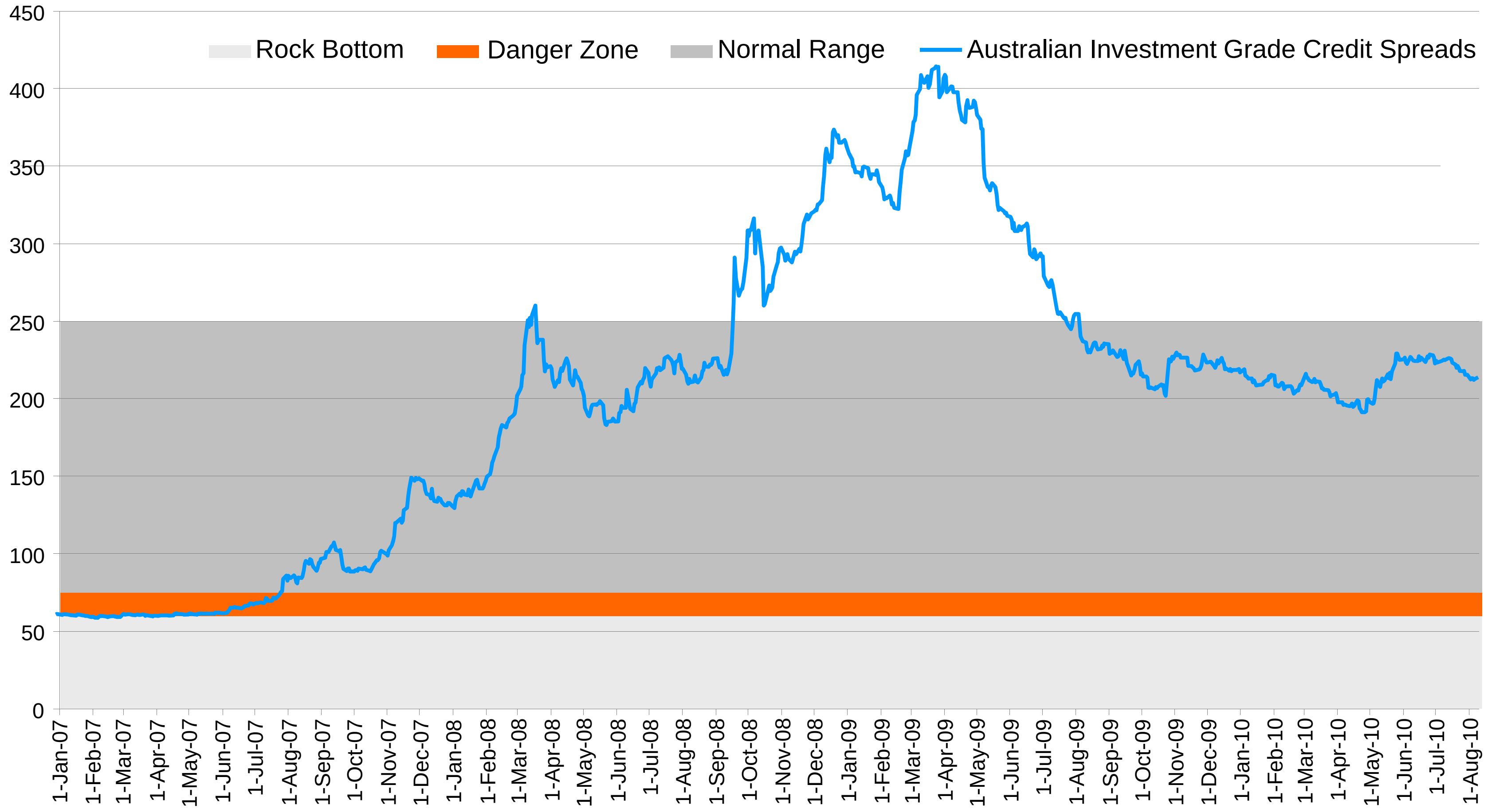
All this is a headwind for credit growth provision and the global and Australian economies

Don’t forget the Australian bond market

- According to the Australian budget, a return to surplus is forecast by 2012-13
- Australia looks set to retain sovereign rating
- Strong employment data: 141,000 jobs created YTD (May)
- Sound banking system – without the global ‘woes’
- Corporate balance sheets in good shape
- Bank funding is still limited to some sectors

Despite these positives corporate bonds remain at wide spreads due to global concerns

Credit spreads remain very wide pricing in much of the downside



Source: AMP Capital Investors

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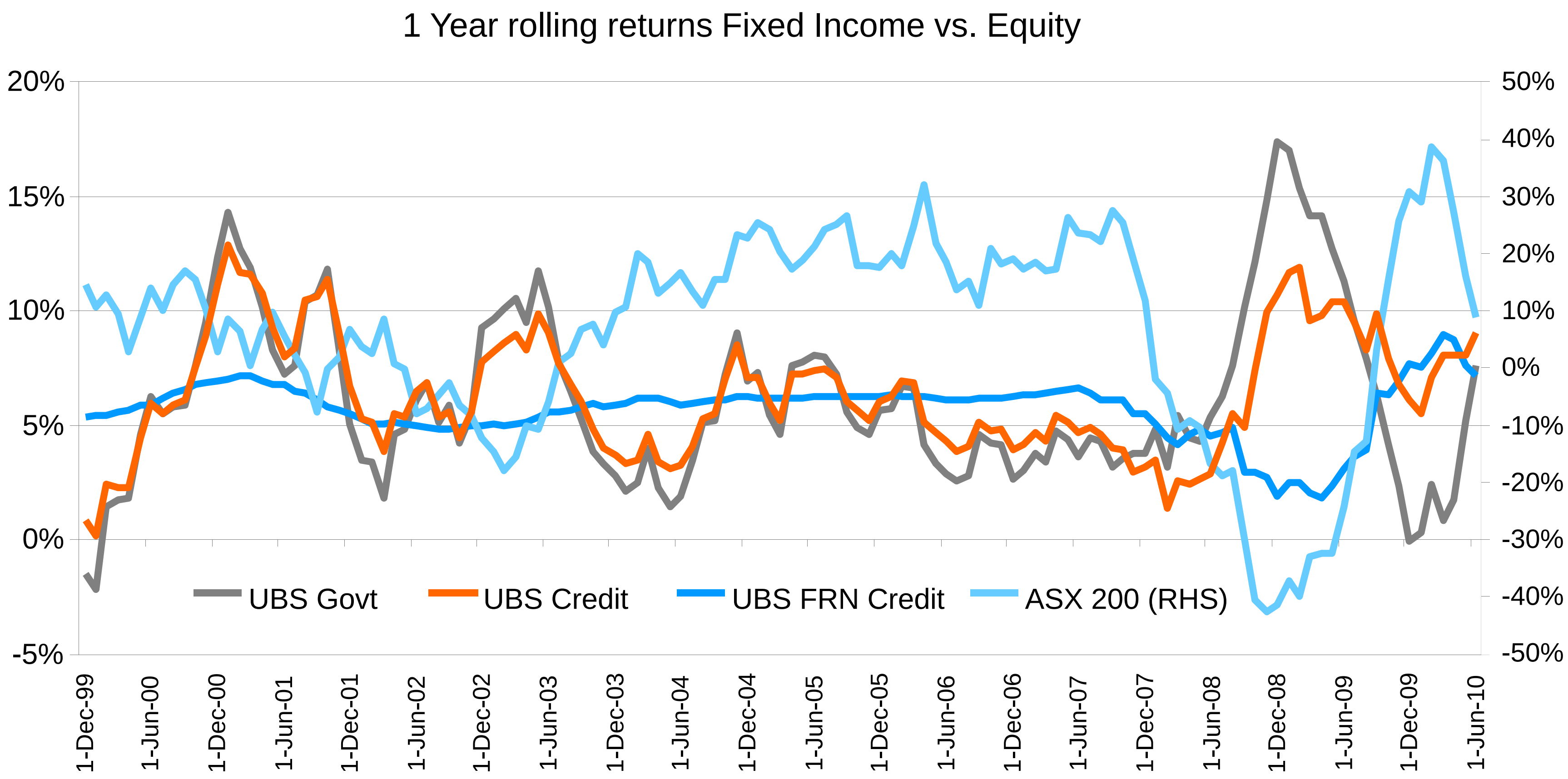
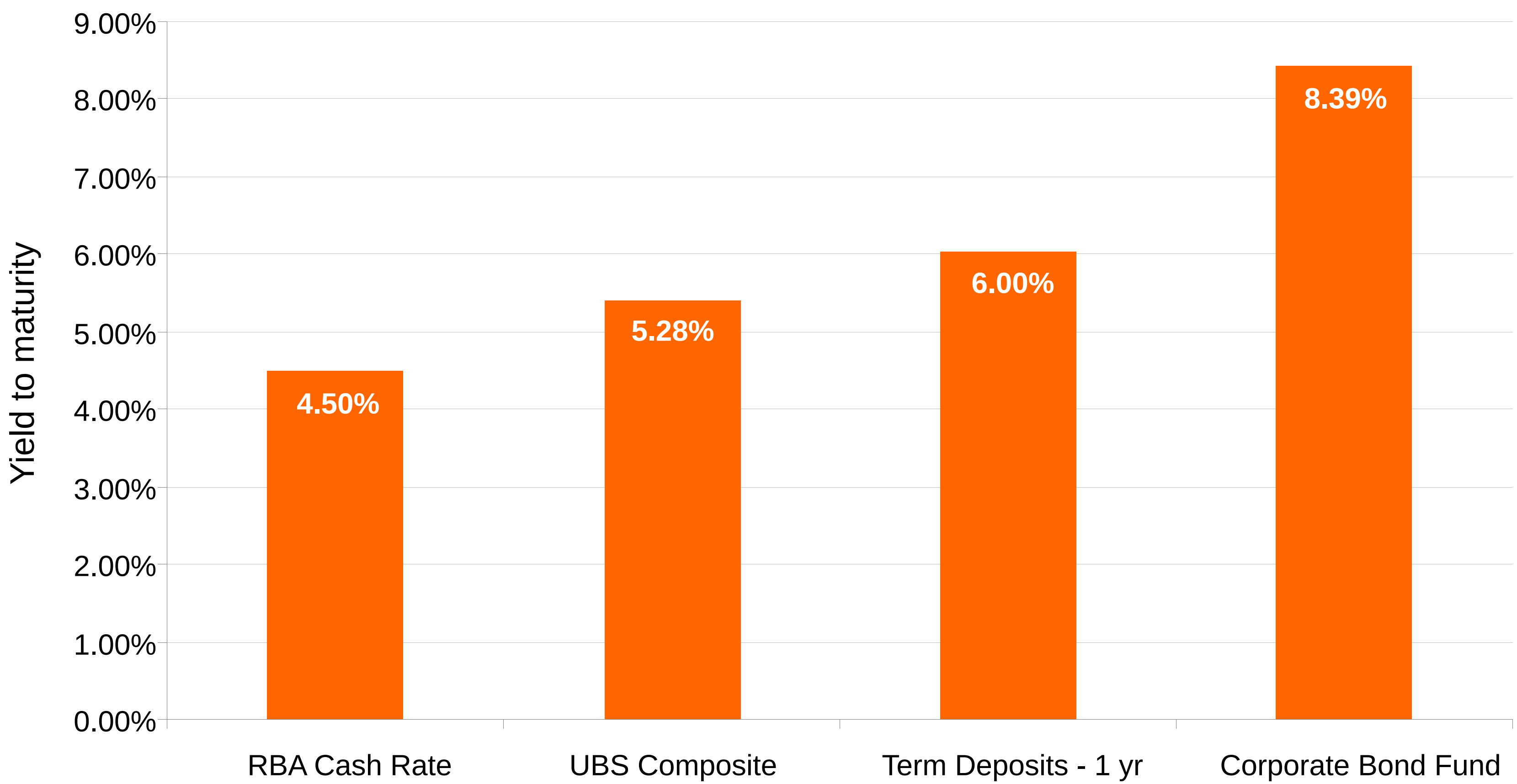
Fixed income versus equities – corporate bonds with duration a good diversifier



Credit provides an attractive alternative



Source: RBA, AMP Capital Investors, UBS
As at 31 July 2010

Look out for sustainable growth

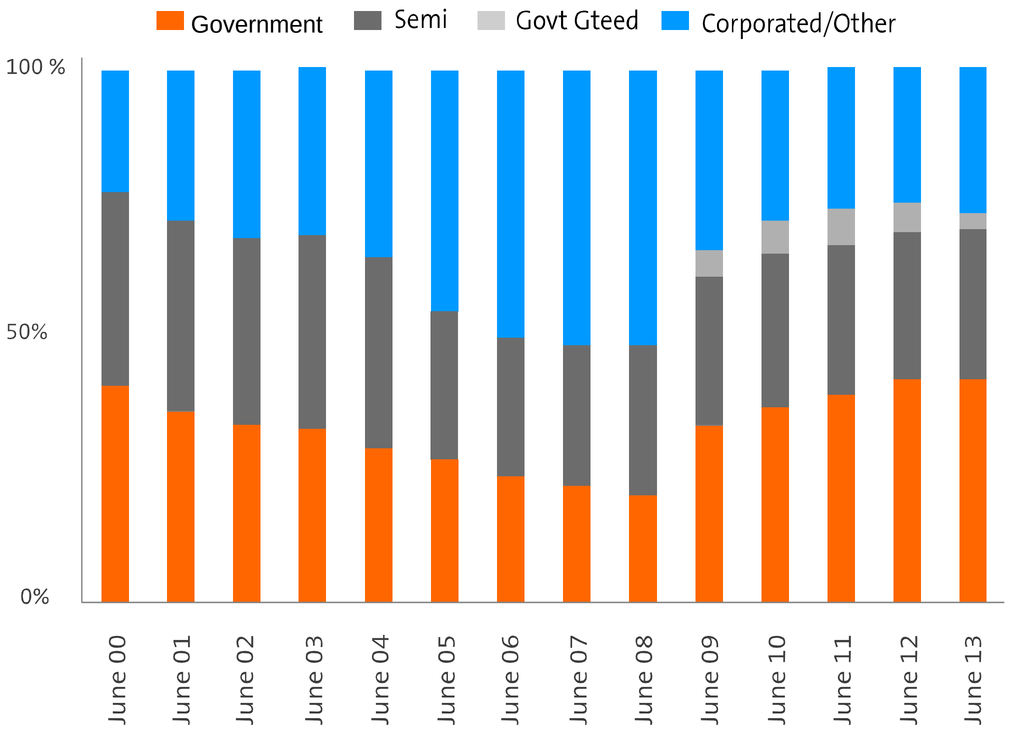
	Scenario	Cash, credit or equity outperforms?
A	Tightening (increases) in interest rates. Consistent with steady (sluggish) recovery.	Credit or equity a close match
B	2010 double dip recession in developed world leads duration having positive performance impact. Spreads do not reach 2008 wides.	Long duration credit outperforms
C	Global growth surprises on the upside, leading to cash rates and yields rising to above normal levels.	Equities

Source: AMP Capital Investors

Successful fixed income investing will:

- Blend Macroeconomic forecasts, proprietary research and company insights
- Involve less reliance on market capitalisation derived benchmark exposures for efficient capital allocation
- Use active management through the cycle

UBS Bond Index – by bond type (% index)



Source: UBS and AMP Capital Investors

Conclusions (and tips)

- In a two speed economy, prepare for Asian currencies to appreciate
- Global economy will be sluggish, even in China, relative to last 10 years
- Limited bank-led credit growth will constrain GDP growth
- Cost of debt for companies is high and increasing
- (Stay aware of history and economics)

The future will (as always) be a challenge

"The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds"

John Maynard Keynes, The General Theory of Employment, Interest and Money (13 December 1935)

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