Damien Wood, Principal

Spectrum Insights

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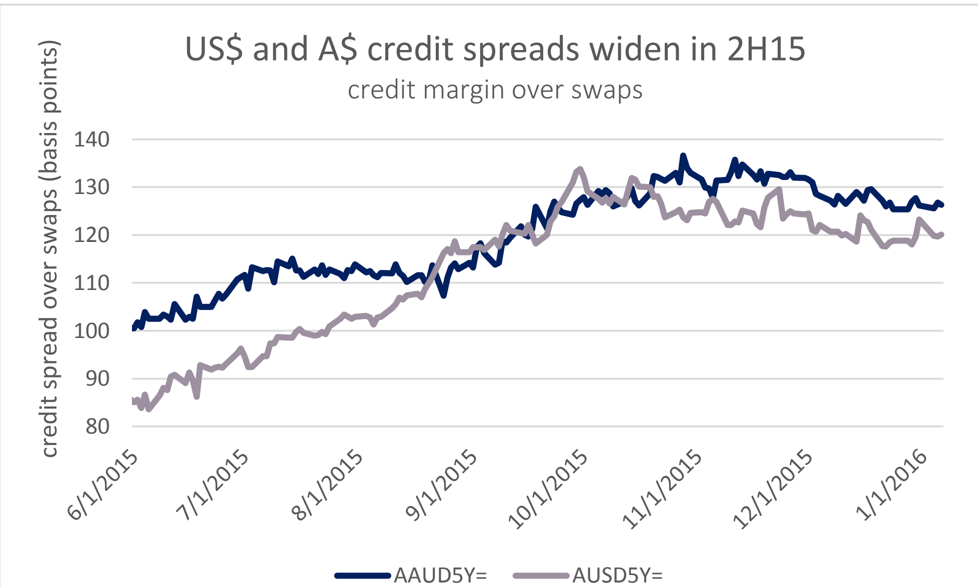
Hard earned but decent returns – 2016 A$ corporate bond outlook

The year 2016 looks like being a battle between greed and fear with regards to Australian dollar corporate bonds' performance. Greed will be driven by investors increasingly frustrated by falling deposit yields. Fear looks most likely to come from abroad, namely, prevailing low commodity prices causing rising defaults in the U.S and problems from emerging markets. The good news is that A$ credit spreads already capture some of this external fear. At the same time, the chance of widespread A$ bond defaults appears low. Investors in well-managed credit funds are set to get healthy returns for the default risk taken. The earnings, though, may be hard earned. Contagion from outside Australia could make for a bumpy, albeit ultimately rewarding, ride this calendar year.

Modest returns in 2015

2015	Fixed Index	Floating Index	1 year deposit	ASX 200 Total Return	Global Equity (hedged)
Total return	2.6%	2.7%	3.1%	2.3%	3.0%
Volatility of returns	0.8%	0.1%	0.0%	4.0%	4.1%

Sources: Spectrum, Reuters, Investing.com

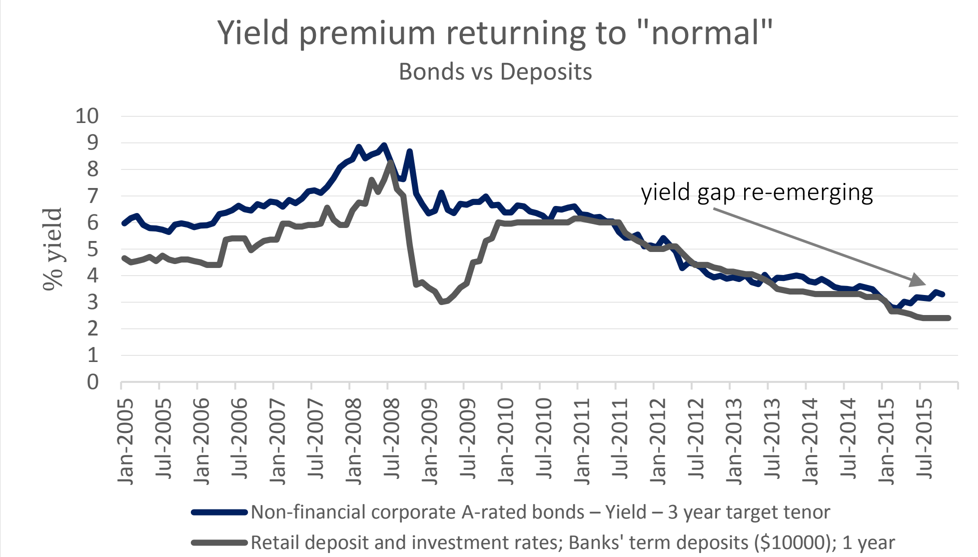


Source: Reuters

Corporate A$ bonds - what's the attraction?

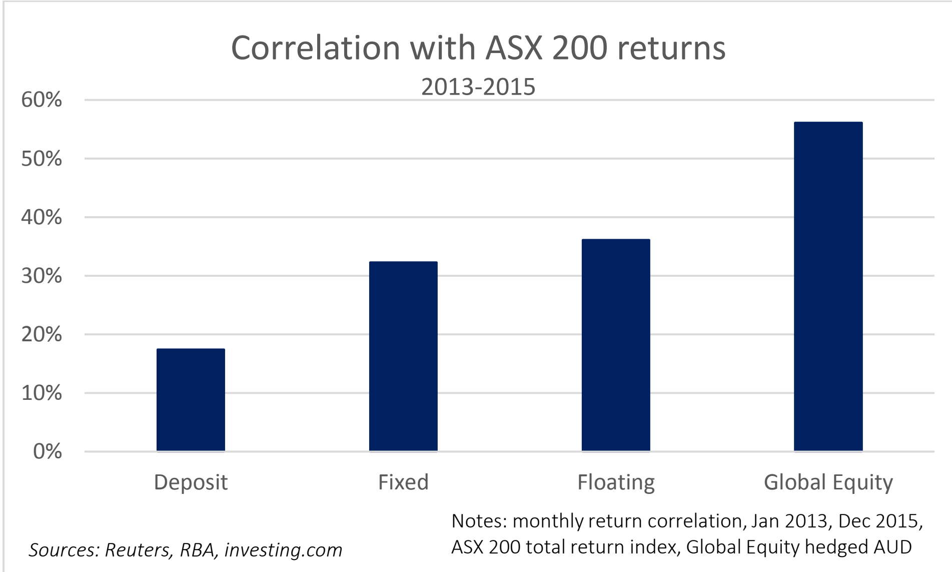
There are several key reasons why investors may consider A$ corporate bonds as an investment for 2016.

- **Income:** For example, a 3 year "A" rated bond in A$ now yields around 3.5%. This is not great but is looking increasingly attractive when compared to the prevailing deposits rates, as the below graph illustrates. As we noted in *No corporate bonds? Time to reconsider – Nov 2 2015*, post-GFC, Australian banks were engaged in a deposit gathering war. This was to appease regulators and rating agencies who wanted them to reduce their reliance on offshore lenders. The war has now ended. The premium that corporate bonds provide over bank deposit rates is more typical, and Spectrum believes this may improve in the coming year.



Sources: RBA, Reuters

- **Diversification:** Corporate bonds have given investors a degree of diversification from their local stock market holdings. We believe this will continue in 2016. If investors are worried about rising US government bond yields and their impact on Australian government bonds and local equities, as we are, then floating rate corporate bonds should provide additional price insulation against this.

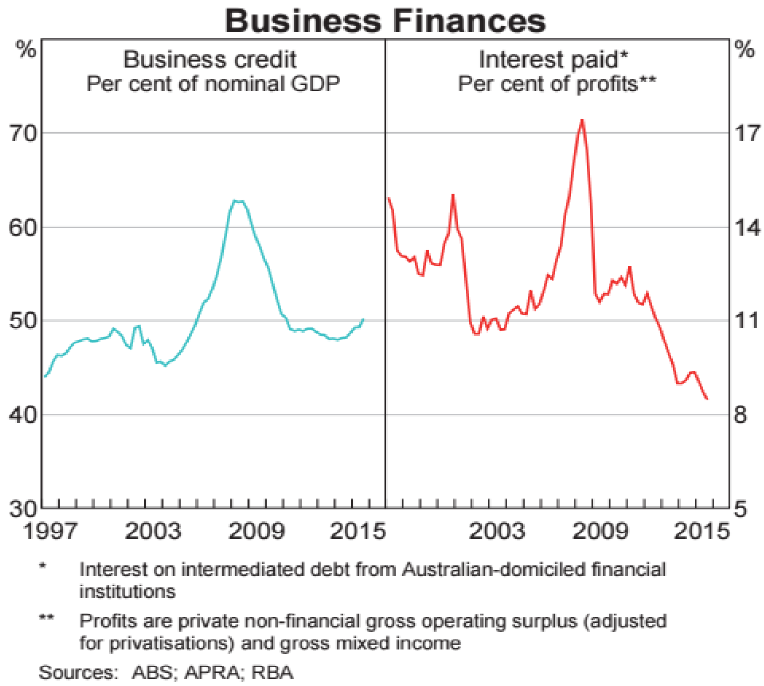


- **Less volatility**: Corporate bonds have provided investors with less volatility than equities in the past, as shown in the table below. We expect this to continue in 2016, in particular, floating rate notes.

Volatility of (SDEV) Monthly returns					
	Deposit	Floating	Fixed	Global Equity	ASX200
July 2005 to June 2007	0.0%	0.0%	0.5%	2.1%	2.4%
Jan 2013 to Dec 2015	0.0%	0.1%	0.7%	3.2%	3.7%
July 2005 to Dec 2015	0.1%	0.3%	0.8%	4.0%	4.1%
Sources: Spectrum, Reuters, RBA, Investing.com	Notes: Deposits are 12 months. Floating and Fixed refer to the Bloomberg indices. Global Equity is hedged into AUD, ASX200 returns are total returns. Volatility of returns is not annualized.				

- **Value:** Australian credit spreads start at a fairly attractive level. Note that credit spreads are ultimately to compensate investors for the risk of default. Implied default for the next 5 years for Australian BBB corporates at a credit of around 180bps is around 5%*. Defaults are rare in A$ notes. This is mainly due to the fact that the vast majority of issues are investment grade, and, most issuers are Australian-domiciled and Australian has not had a recession since the early 1990s. Looking forward, the risks look low as well. At present, the Australian corporate sector, overall, appears to have strong credit profiles, as illustrated in the graphs below. Spectrum believes that the implied default rates for A$ issuers are a large overstatement of what the actual levels will be.

  * Spectrum presumes a 50% recovery rate and incorporates other contributors to credit spreads such as price volatility, rating volatility, liquidity premium and time value.

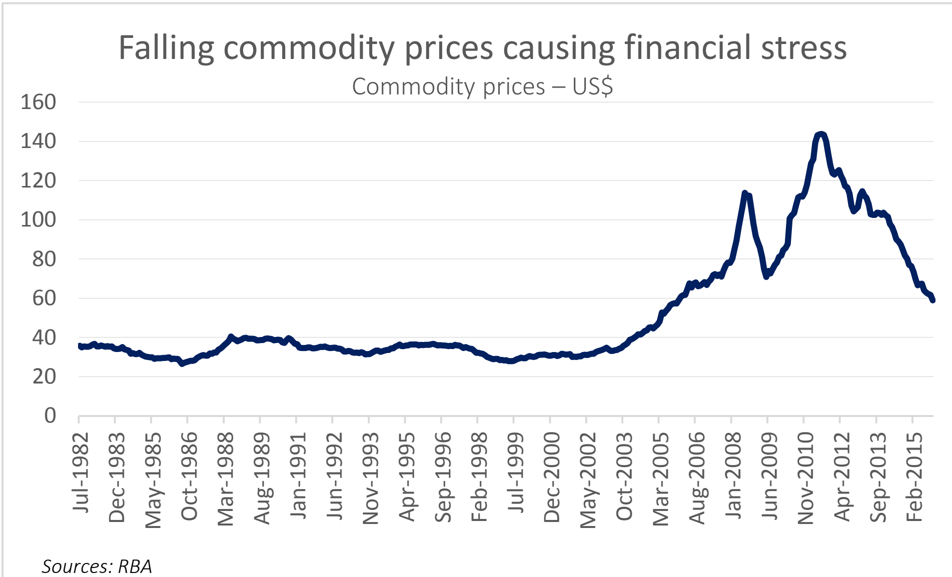


What are the risks?

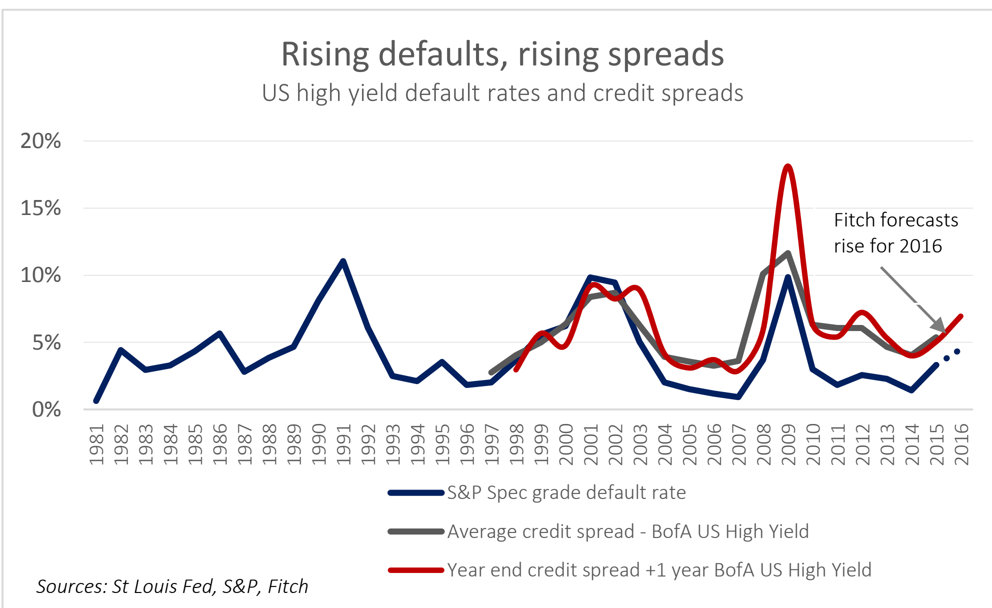
Of course, risks exist for any asset class. Our key concerns for A$ corporate bonds are as follows:

- U.S. default rates soar to recession-like levels, say 8% as opposed to 4.5-5% base case. We consider this to be a low risk, say 5%.
- U.S. high yield market's spreads markedly overshoot realised defaults. This is a higher risk, say 20%, but its impact will be transitional.
- Emerging market problems, including those from China, skyrocket. For example US$ bond issue default rates climb from the current 4% to, say, 10%. We consider this to be a 20% chance and, again, its impact will be transitional.
- U.S treasury yields rise, say 0.5% to 1%, causing government bond yields in Australia to rise and inflicting losses to fixed rate investors. We consider this to be a 35% chance.
- A surge in A$ bond defaults to say 3% default rate. We consider this to be a 5% chance.

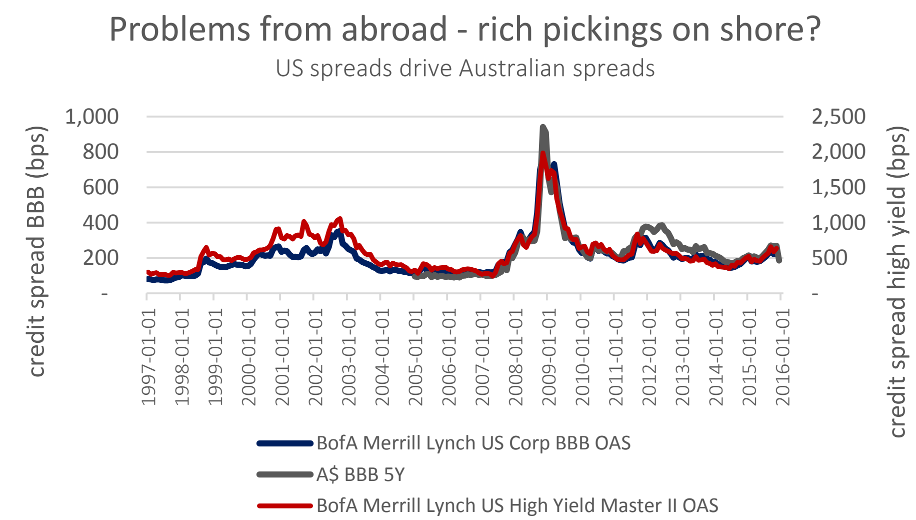
Plummeting commodity prices are the primary reason behind these concerns over rising defaults. Many projects were funded by bond issues on the basis of commodity prices, in particular oil prices, at far higher levels than the prevailing levels. However, the expected increase in the supply of oil and some other commodities in 2016 does not bode well for a recovery in prices. Add to this mix, the surge in debt issuance from these sectors in recent years, and the foundation has been laid for a rise in defaults among second tier commodity-linked issuers.



Fitch, a major credit rating agency, forecasts speculative grade defaults from the U.S to increase from 3.3% in December 2015 to 4.5% by mid-2016. In the past, credit markets have tended to reasonably anticipate rising defaults but only up to 12 months in advance. We presume this relationship will broadly persist.



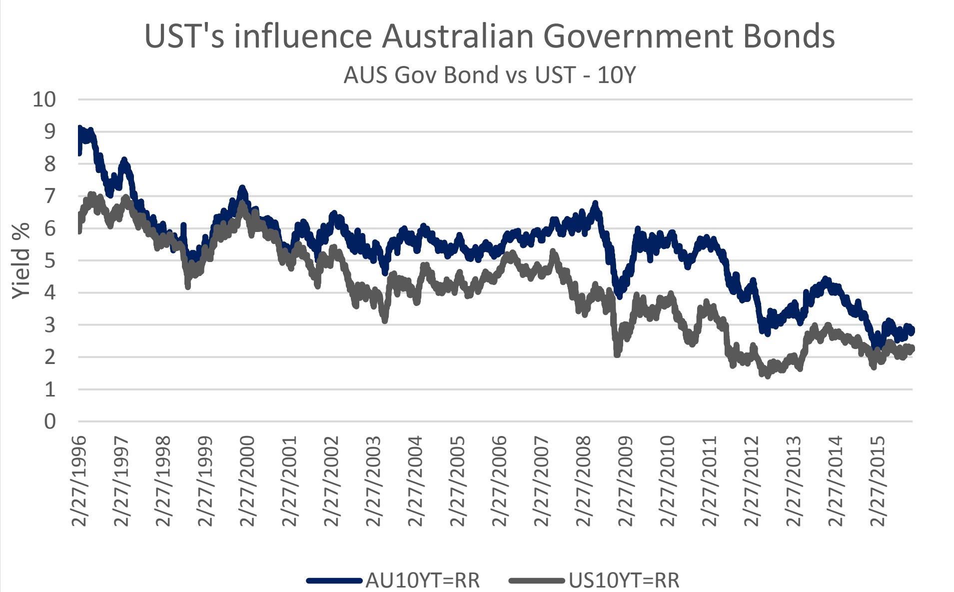
Unfortunately, Australian credit markets tend to be highly influenced by what happens abroad, in particular in the U.S., even if domestic credit conditions are robust.



Sources: St Louis Fed Reserve, RBA

How to reduce these risks

- **Credit risk:** First and foremost, avoid investing in issuers whose bonds default.
- **Credit spread risk**: Second, maintain a relatively high proportion of short-dated notes in the portfolio to reduce the contagion impact of deteriorating offshore credit markets.
- **Interest rate risk:** Third, maintain the bulk of corporate bonds in floating rate notes to shelter from rising U.S Treasury (UST) yields.



Source: Reuters

The truth of corporate bonds

An oft used quote from Warren Buffet is, “Price is what you pay, value is what you get.” The beauty of corporate bonds is that you have a finite time of realizing this value. Each interest payment is an affirmation you are on the right track and repayment of the principal is the confirmation. In contrast, an equity price can remain at odds with your views *ad infinitum*. Right now, investors are getting value, well-rewarded for the A$ credit risk taken in our view. The year 2016 may produce relatively high volatility but if one’s credit calls are right, attractive returns look set to follow for well-managed credit funds.

Spectrum Asset Management manages the Spectrum Strategic Income Fund. This fund invests in AUD corporate securities of which the majority are floating rate notes. The intention is to make this portfolio relatively immune from the bond yield volatility which can, in turn, hit equity and fixed income markets. The fund is also designed to deliver an income stream while generating capital gains from time to time. For more information and how to invest please go to our website http://spectruminvest.com.au or contact your mFund broker http://www.asx.com.au/mfund/foundation-members.htm#tabs-218. Spectrum and the author have investments in either securities mentioned in this report or comparable securities