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Spectrum Insights

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Picking up pennies in front of a steamroller

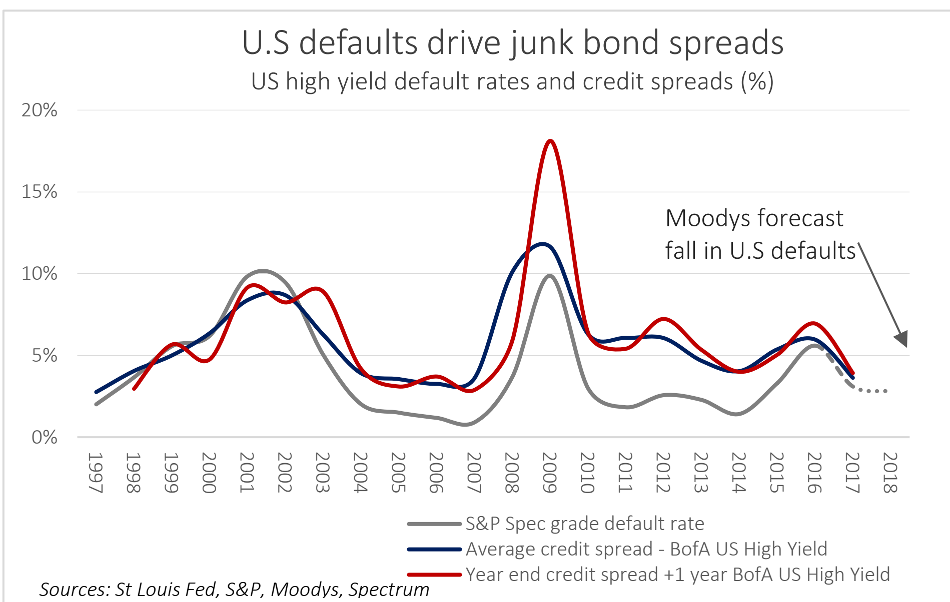
The title above is an old analogy used by some corporate bond investors to describe their job. The returns come in small steady amounts (pennies). One slip, however, and the damage can be painful. The risk of getting "run over by a steamroller" appears ever more relevant today. A slowing or reversal of central banks' ultra easy monetary policies risks losses for many assets including fixed rate bonds. That's the bad news. The good news for corporate bond investors is international and Australian default rates are set remain low or even fall. This supports steady returns for A$ corporate bonds, in particular those with floating rate notes, for at least the coming months.

Tight and getting tighter

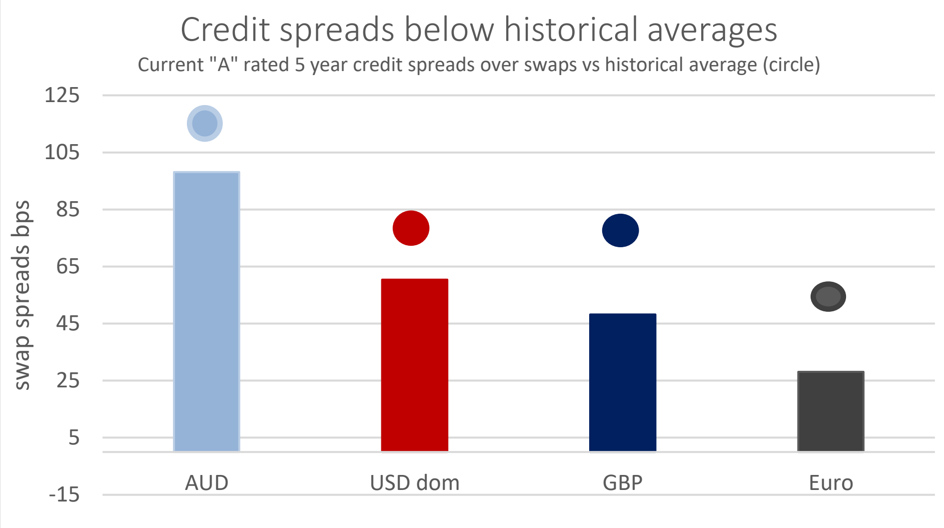
Default rates in the U.S and Europe are likely to remain low and are poised to fall due to:-

- steady economic growth
- low interest rates
- easy refinancing conditions, and
- a modest recovery in commodity prices

In turn this usually means lower credit spreads in those markets.

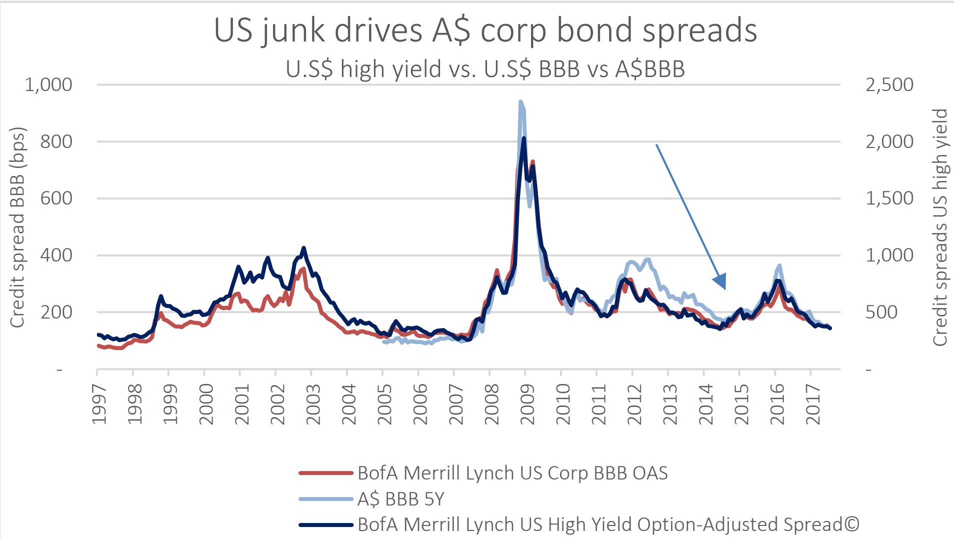


The margins currently compensating investors for corporate bond default risk in Australia and elsewhere are below historical average.



Sources: Thomson Reuters, Spectrum Asset Management

Despite the relatively low credit spreads at present they are poised to get tighter. This is largely due to expected low default rates offshore as discussed above. The A$ corporate bond market is likely to continue to track international trends.

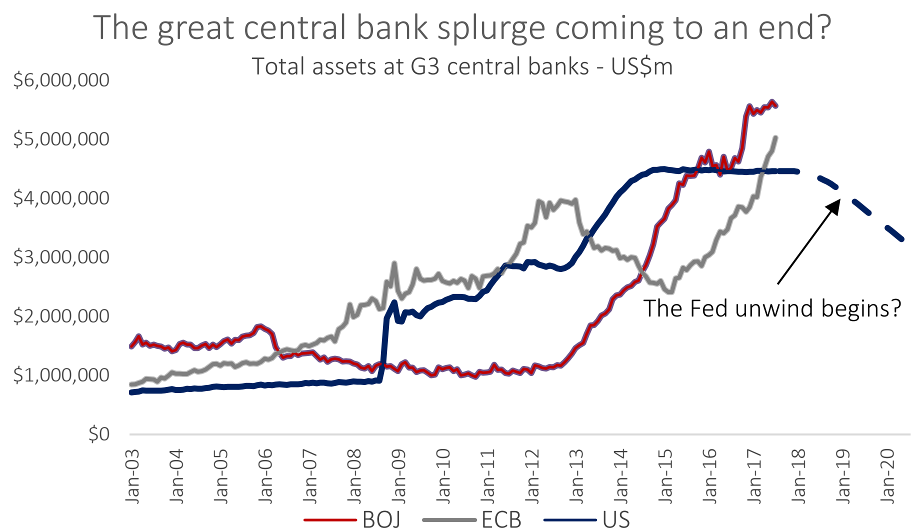


Sources: US St Louis Fed Reserve, RBA

Slowing, stopping, reversing and then run over by a steamroller?

Global asset prices have risen sharply in recent years. Much of this is linked to uber supportive central bank policies. The graph on the following page shows that G3 central banks today hold almost the equivalent of US$10t of assets. The distortion on valuations is most notable in government and high investment grade fixed rate bonds. Now around US$9t of bonds globally have negative yields.

The US Fed has stopped growing its holdings. It may soon announce plans to slow re-investing proceeds from maturing bonds. The market eagerly awaits guidance from the ECB as to when it will further slow and reverse its quantitative easing plans.



Sources: US St Louis FED, Spectrum

The growth in surplus global investment liquidity will eventually slow. Then it will reverse. And as this reversal approaches, the risk of asset price declines rises.

Insane or rationally invested?

Fixed Income investors pride themselves as being rational. Corporate bond investors typically see themselves as conservative. If this is the case then how can they and Spectrum justify investing in bonds at present given the comments above?

We have little exposure to the main asset class central banks currently own – fixed rate bonds. Most of our exposure is in floating rate notes. The prices of these assets are largely sheltered from rising bond yields.

We also note that corporate bonds do not look cheap. But default rates are low globally and near non-existent in Australia. Moreover, the expected fall in defaults offshore will help push credit spreads lower onshore. If so modest capital gains should follow. Hence, while at times our sanity may be questioned, we can point to fundamentals as the foundation of our investments.

A contender in the relative ugly contest?

Most key asset classes boomed in value in recent years. A large contributor to this was central bank stimulus. Now investors face the uncertainty of what happens when quantitative easing is reversed. On current valuations few assets look cheap to us. Investing is becoming not so much a question of what is the most attractive but what is the least ugly.

Returns for A$ floating rate corporate bonds, in general, are likely to be lower in the near term than the recent past. Compared to the risk-return outlook for many other investments, however, A$ corporate floaters look relatively attractive. Default risk looks low, capital values are likely to be preserved, volatility set to remain modest and the yield better than what is available for bank deposits.

In the meantime we will keep picking up pennies for our investors while trying to keep a fair distance from the oncoming steamroller – always paranoid it could accelerate at any time.

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Spectrum Asset Management manages the Spectrum Strategic Income Fund and bespoke corporate bond mandates. These fund invests in A$ corporate securities of which the majority are floating rate notes. The intention is to make portfolios relatively immune from bond yield volatility which can, in turn, hit equity and fixed income markets. The funds are 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.

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