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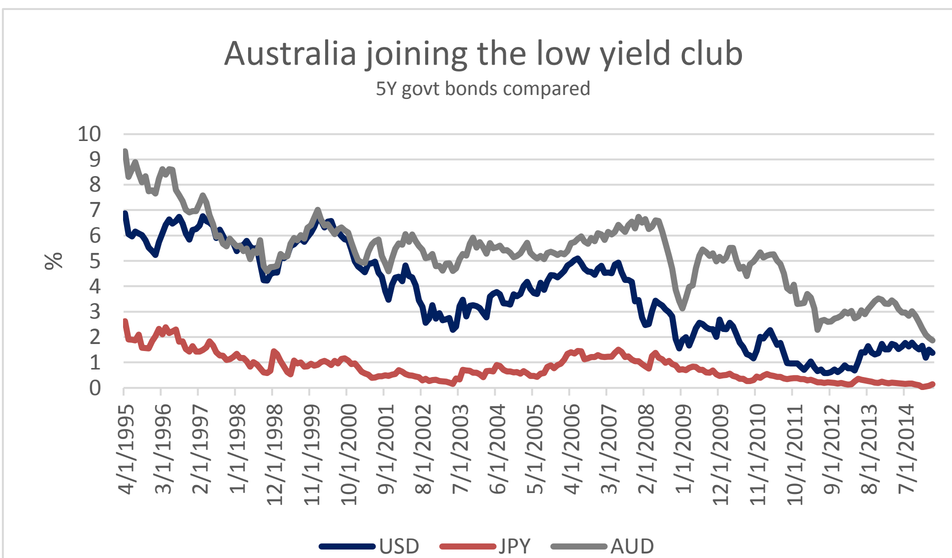
Spreads are poised to go far lower in Australia

Turning Japanese

Credit spreads of Australian dollar corporate debt issues are set to mimic what has happened in Japan following that country's sustained ultra-low yield environment, that is, fall to low levels. In turn, this should generate attractive credit returns for many AUD corporate notes over the coming year.

Australia is no Japan. There is no demographic time bomb and Australia's sovereign debt level is highly sustainable.

Australian government bond yields, however, have sharply narrowed their margin over their Japanese equivalent over the last 18 months. Until there is either new found inflation fear or international quantitative easing stops, AUD government bond yields look set to remain near historically low levels.



Source Reuters

In combination with near historic averages for local credit margins and subdued default rates, credit spreads are poised to go far lower in Australia. This should result in attractive returns over the next year for many Australian corporate debt securities.

Credit Theory

Rating agencies provide opinions on the credit risk of a bond issue. These opinions come in the form of credit ratings. Credit ratings are the market's benchmark of assessing this risk. The ratings are intended to be stable and cover a foreseen economic or business cycle. In theory, if the ratings are stable, a bond's credit spread should not change greatly due to changing bond yields within their normal range[1].

That's the theory. The reality is different from two perspectives.

Greed and little to fear

Greed: As bond yields fall, investors often seek to restore their previous returns. Frequently, this is done by increasing credit risk. The lower the market yield, the more credit quality investors may be prepared to give up for the same credit spread.

Intuitively, this makes some sense. For example, if the 5 year government bond yield is, say, 10%, a BBB rated 5 year corporate bond at 11% does not look overly compelling. As shown in the box below, an investor improves overall yield by just 10% in compensation for taking an 8 notch credit rating downgrade in bonds.

If the government bond yield is 2%, however, the investor can boost overall yield by 50% by taking the same marginal credit risk.

How much extra spread will you want?

Yield-Spread Scenario	Yield	Yield
5 year AAA government bond	2%	10%
5 year BBB credit spread	1%	1%
Total 5 year BBB bond yield	3%	11%
Credit spreads as % of yield	33%	9%
Credit spread improves yield	50%	10%

Source: Spectrum

This yield chasing scenario is what often happens in a low yield environment. It is not just greed, though, that drives credit spreads. There is some fundamental logic behind this investor behavior.

Little to fear: Credit spreads primarily compensate investors for risk of loss from a default. Default risk moves when economic conditions change. Corporate bond investors adjust credit spreads far more than rating agencies adjust opinions to reflect where they see they see the issuer or market is in the overall default cycle.

[1] Discount rates, of course, have some impact on the net present value of 1) credit spreads, and 2) recovery rates from defaults, in particular, where the proceeds from the work-out take several years. The impact that varying interest rates have on the net present values on credit spreads, though, in most historical ranges, is moderate relative to changing credit profiles of the underlying issuer.

Specifically, in a sustained low interest rate environment, default rates are usually below historical norms. This is due to two factors. First, debt is relatively easier to service due to the low interest rates. Second, the ability to source replacement finance is often easier as a result of accommodative monetary policy as the market is flush with liquidity.

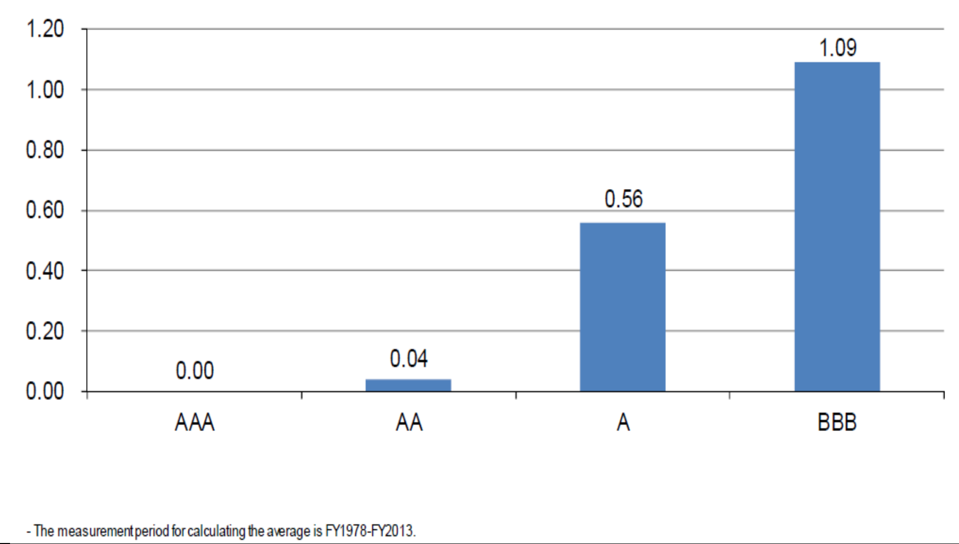
Put crudely, the market sees a BBB rated issuer as being much less risky in a low yield environment than in a high yield environment.

Lessons from abroad

Historically low credit spreads will not happen just because of low market yields. Low default rates support lower credit margins. As noted in the chart below, Japanese Yen corporate bond default rates were moderate in recent periods. Today, Japanese 5 BBB year corporate bond credit spreads are in the region of just 20bps compared to around 125bps in Australia.

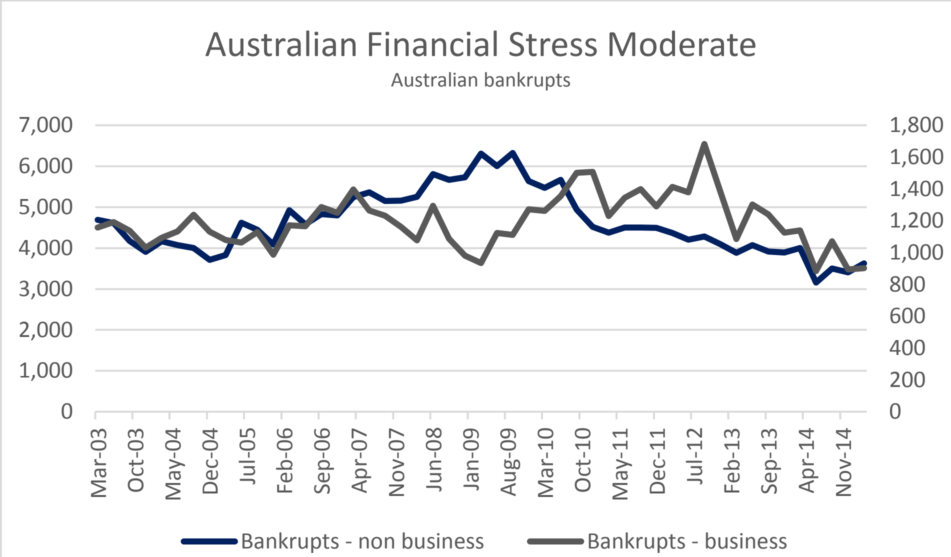
Low default rates in Japan

Japanese average 5 year cumulative corporate default rates 1978-2013



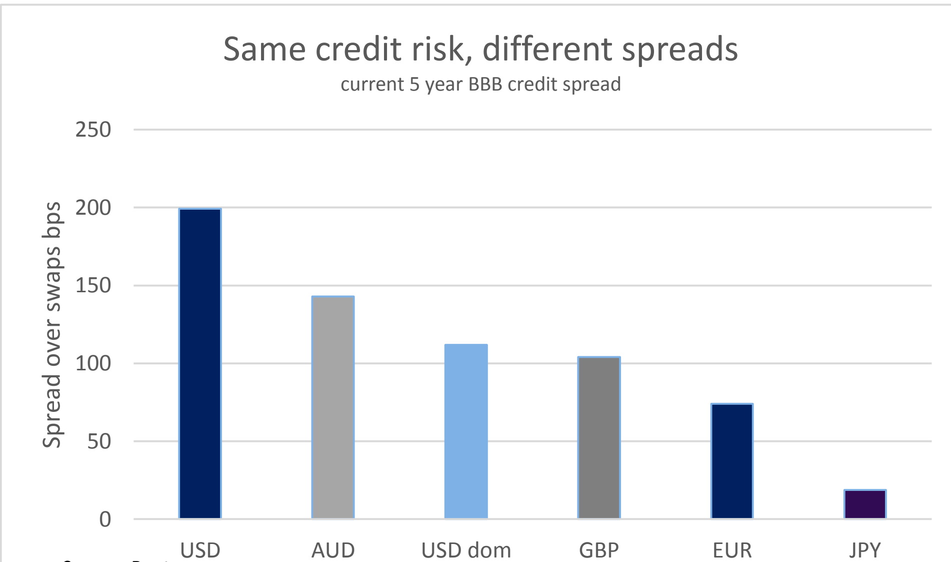
Source R&I

At present Australian financial corporate stress is low. In Spectrum's view, it is set to remain low for the coming year.

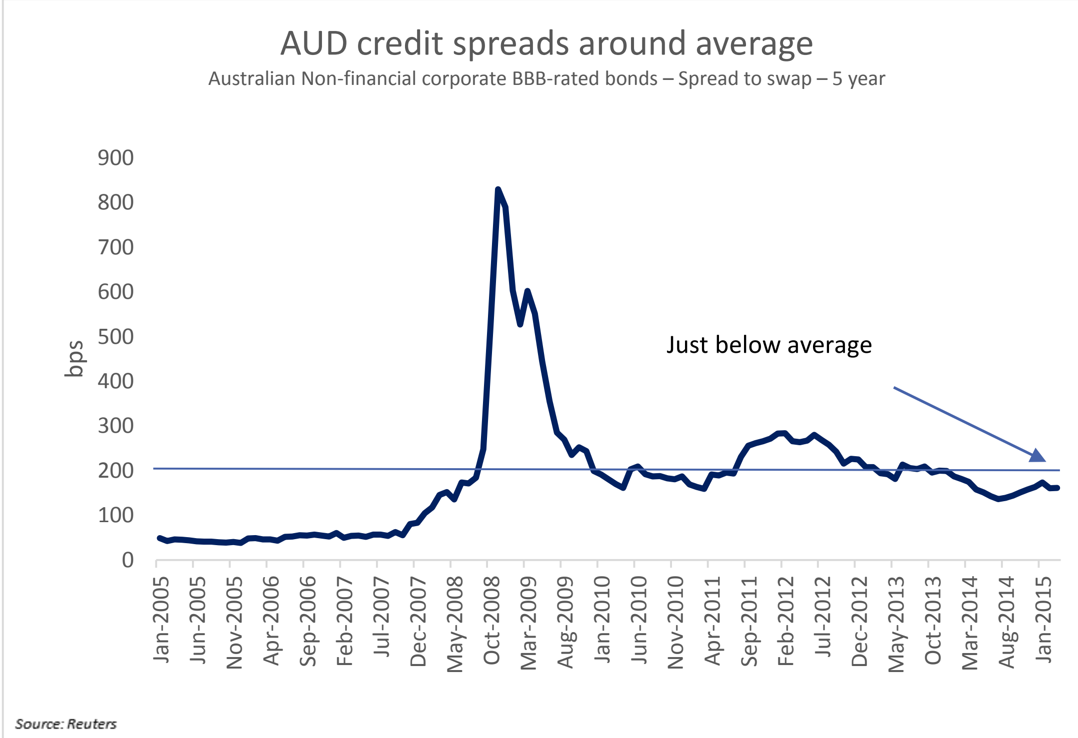


Source: AFSA

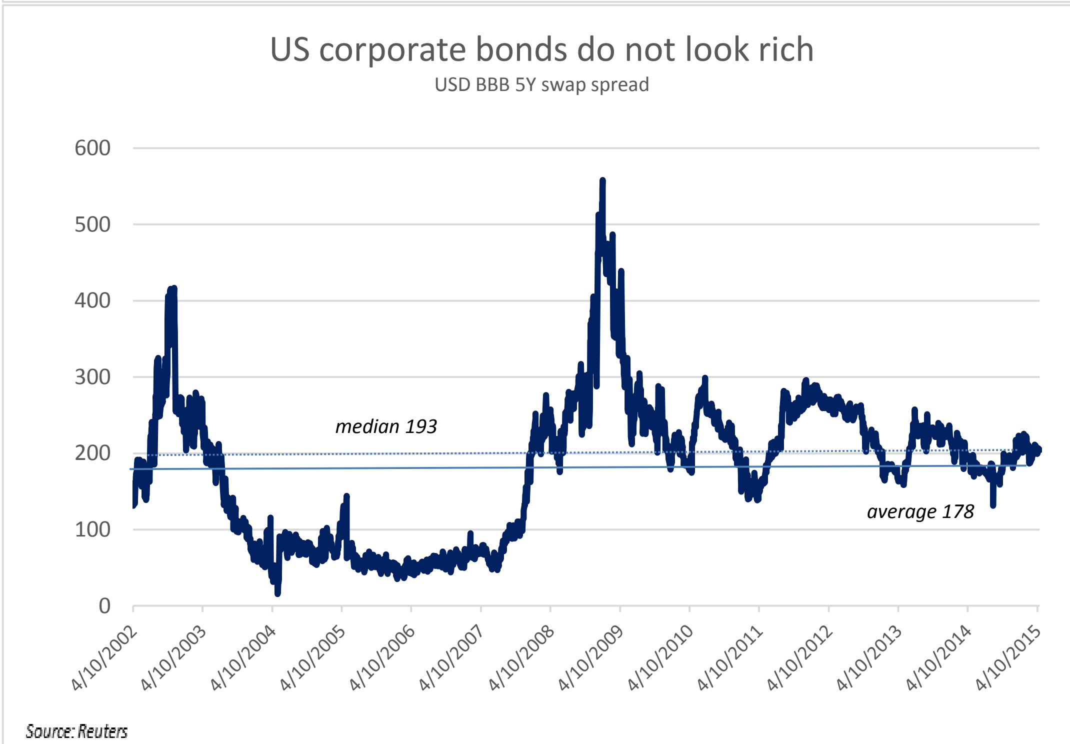
These trends and influences are now playing out in other countries. Many have corporate credit spreads well below historical averages.



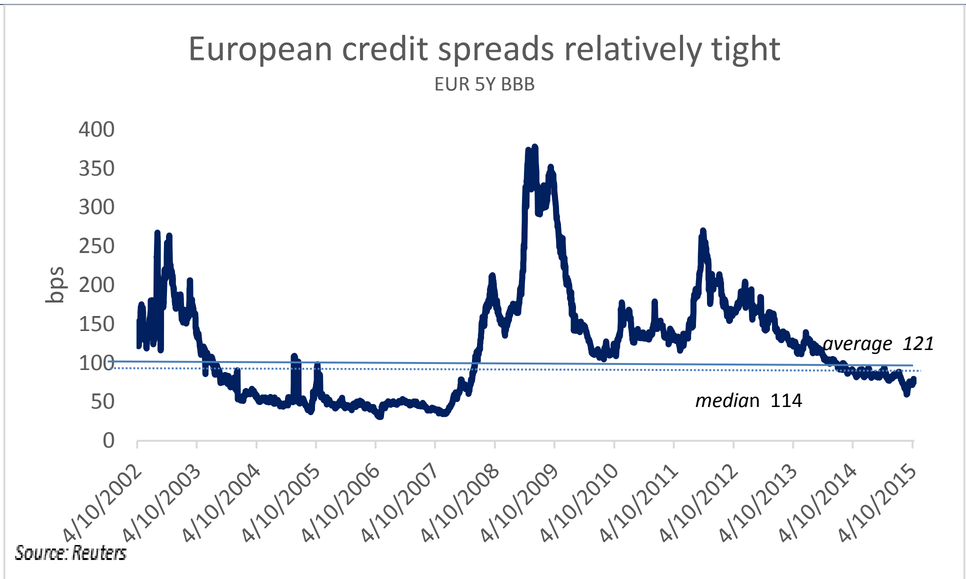
Source: Reuters



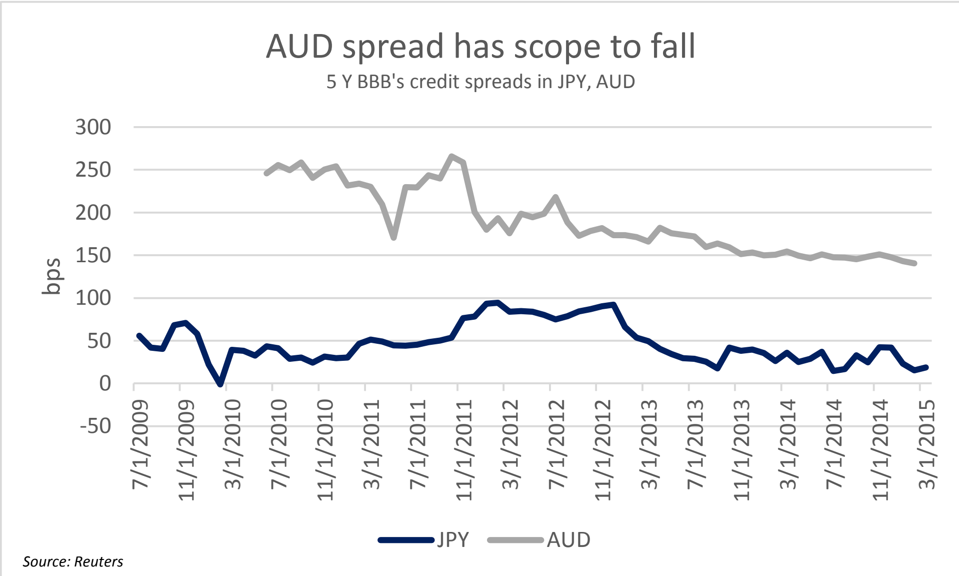
AUD credit spreads around average
Australian Non-financial corporate BBB-rated bonds – Spread to swap – 5 year
bps
Just below average
Source: Reuters



US corporate bonds do not look rich
USD BBB 5Y swap spread
median 193
average 178
Source: Reuters



Of note, many other markets are now trading markedly below historical average credit spreads. Australia is hovering around its historical average. Looking forward, Spectrum foresees the yield and default environment in Australia will support lower credit spreads for AUD notes as well.



Reasonable returns

Spectrum expects credit spreads in Australia to fall in the region of 15% in the coming year, driven by the prevailing low yield environment. Together with expected low default rates and sustained positive investor sentiment, we envisage the Spectrum Credit Opportunities Fund to generate returns in the region of 7% over the coming 12 months.

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