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Spectrum Insights

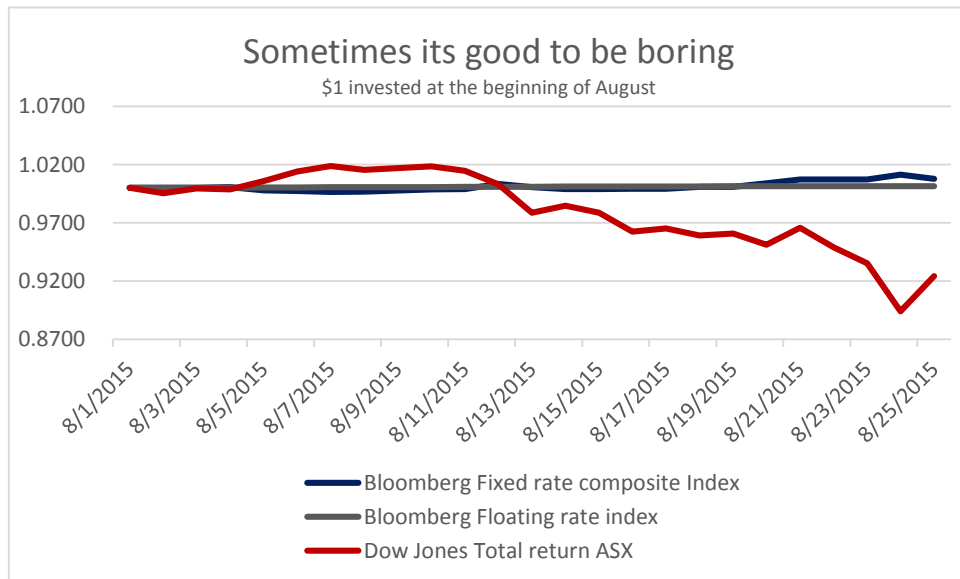
AUGUST 27, 2015

Credit keeps its cool

The extreme investment market volatility in recent days is both good and bad to us. Good in that affirms our view that AUD credit spreads were well supported by fundamentals. Bad in that it did not give us an opportunity to buy cheap bonds. Australian credit markets have performed relatively well in recent days and we expect will deliver reasonably steady credit returns over the coming year. Spectrum believes China's policy response will be sufficient to avoid a sharp slow-down in China's economic growth. This in turn assists Australia's economic growth outlook and reduces the chances of a jump in Australian default rates.

Boring can be good

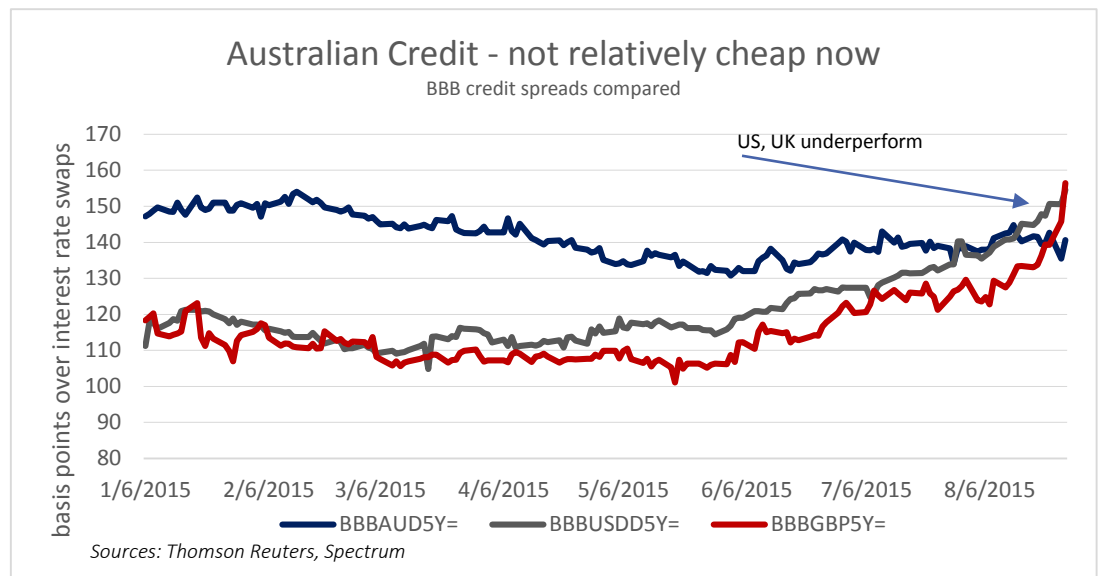
Australian bonds as measured by the key indices below have generated modest but positive returns over the last month. In contrast Australian equities have lost around 8% of their value and are down around 13% from their peak this year.



Different to other credit markets

Australia's credit markets have not just outperformed equities in Australia and abroad they have also outperformed other credit markets. At first this would seem odd. Much of the recent market weakness appears to be linked to slowing Chinese economic growth. Bloomberg's headline during 26 August was "China's Journey from New Normal to Stock Market Crisis Epicenter". Hence given Australia's economic link with China one would expect Australian credit fundamentals to be more at risk than those in the U.S and the UK.

We suspect, though, that Australia's long standing and deep economic relationship with China also has fostered greater investor familiarity with China's economic and policy position than the average credit investor outside of the Asia Pacific region.



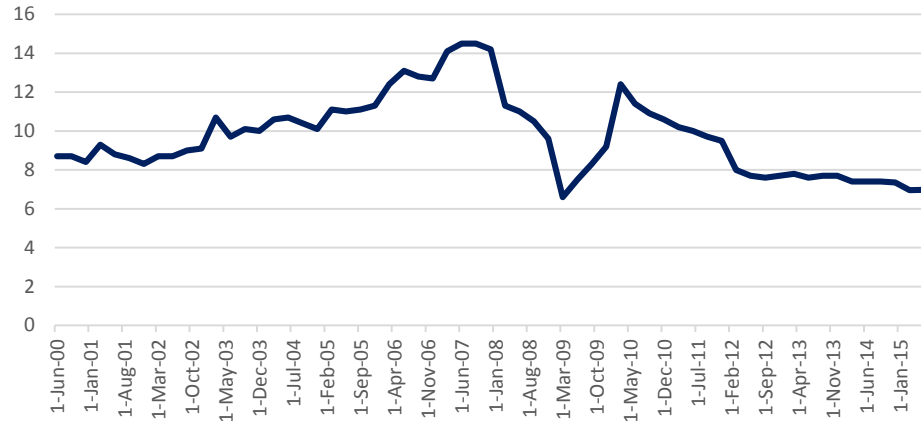
China's Challenges are real and large

History suggests that, as a nation gets wealthier, outsized economic growth, such as China has been achieving, becomes harder to sustain. This, among other challenges such as a shrinking working population and excess capacity in many industrial sectors is making high economic growth a major challenge.

China is used to economic growth in excess of 7%. Much of the investment decision making in the past was premised on strong continued albeit slower growth in the future. Should this not occur widespread financial distress is a key and likely risk.

How low will it go?

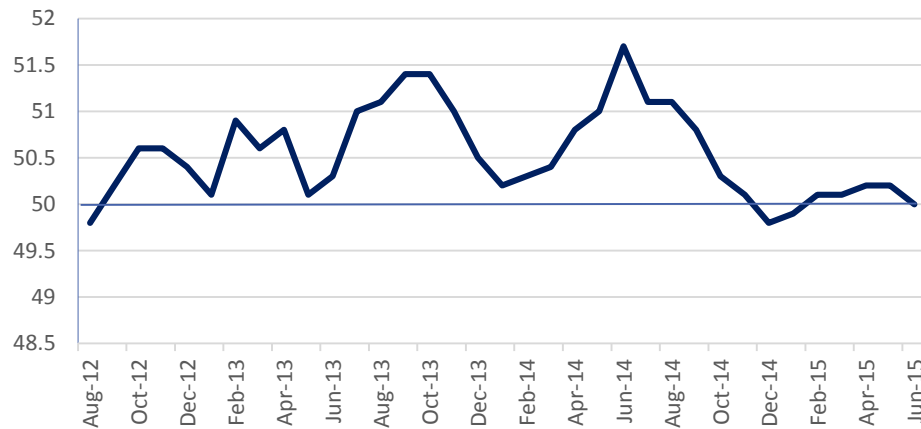
China's annualised GDP growth %



Source: National Bureau of Statistics of China

China Manufacturing Ebbing

PMI



Sources: National Bureau of Statistics China

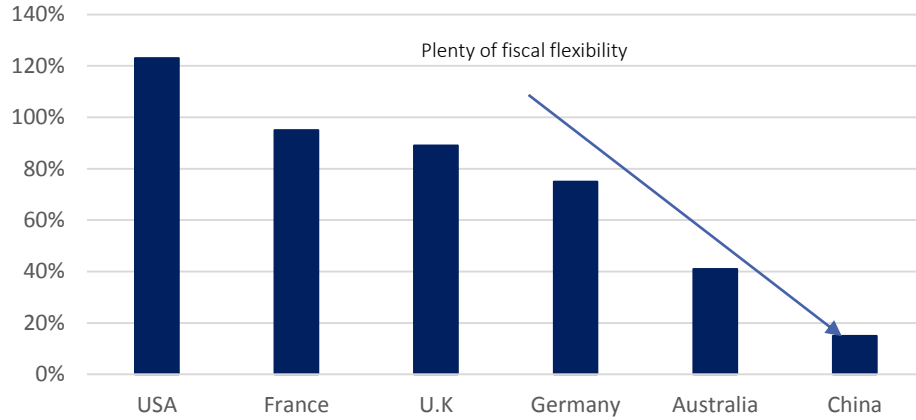
China's policy tools aplenty

Spectrum believes China's policy makers have the fiscal, monetary and policy flexibility as well as the will to help China avoid a sharp sustained slowdown or contraction in its economy.

For example the government has already eased bank rules, cut interest rates, lowered its currency and set several stimulus policy measures. It has ample wiggle room to do more as shown by its relatively low sovereign debt levels. And unlike Australia it will not need be distracted by the wants of minority interest groups to get stimulus policies approved and implemented.

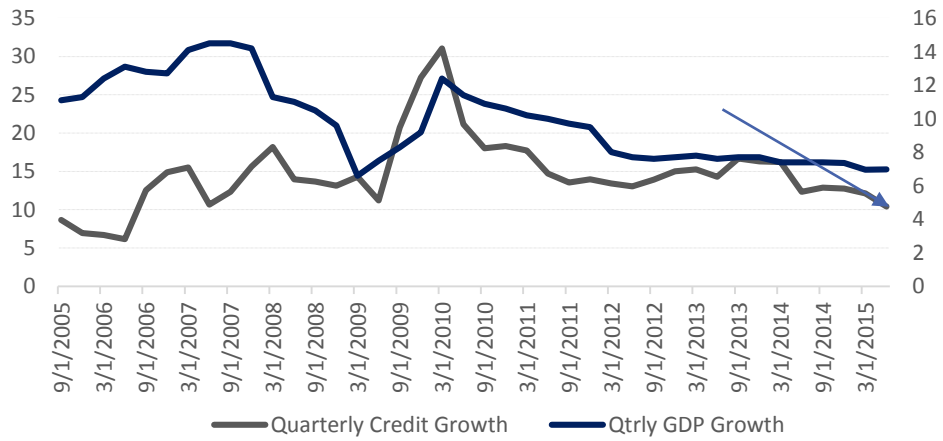
Differing Government Debt Levels

General Gross Government Debt / GDP



Sources: Thomson Reuters, Spectrum

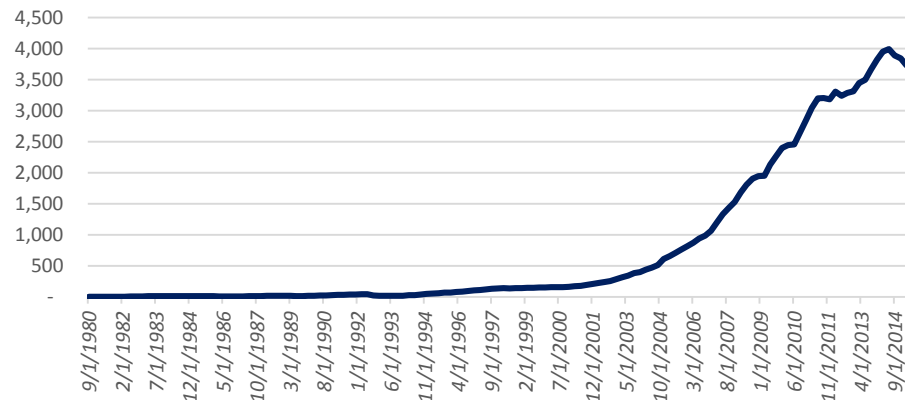
China - bank lending and GDP



Sources: Thomson Reuters, Spectrum

And should the banks need more capital China may again taps its nigh \$US4t in official reserves.

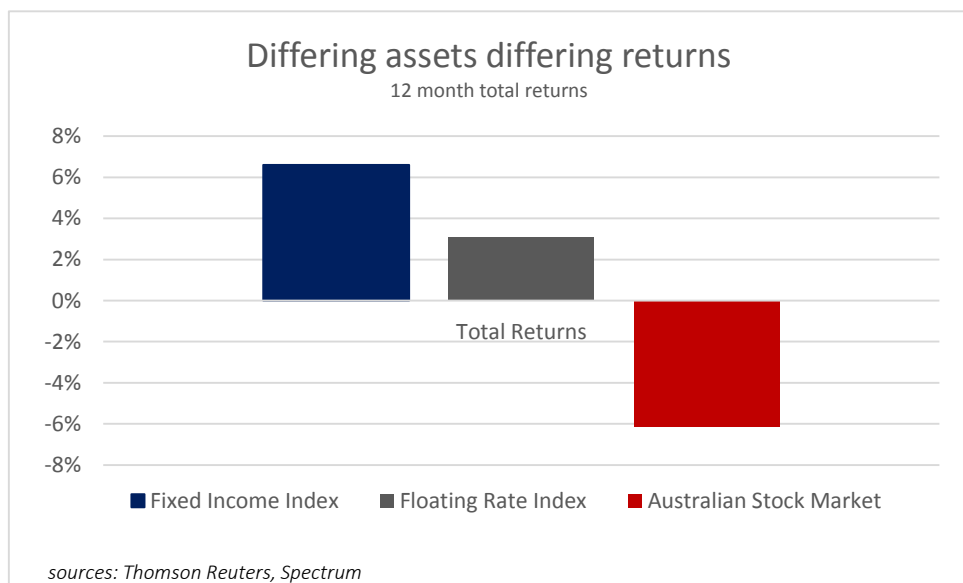
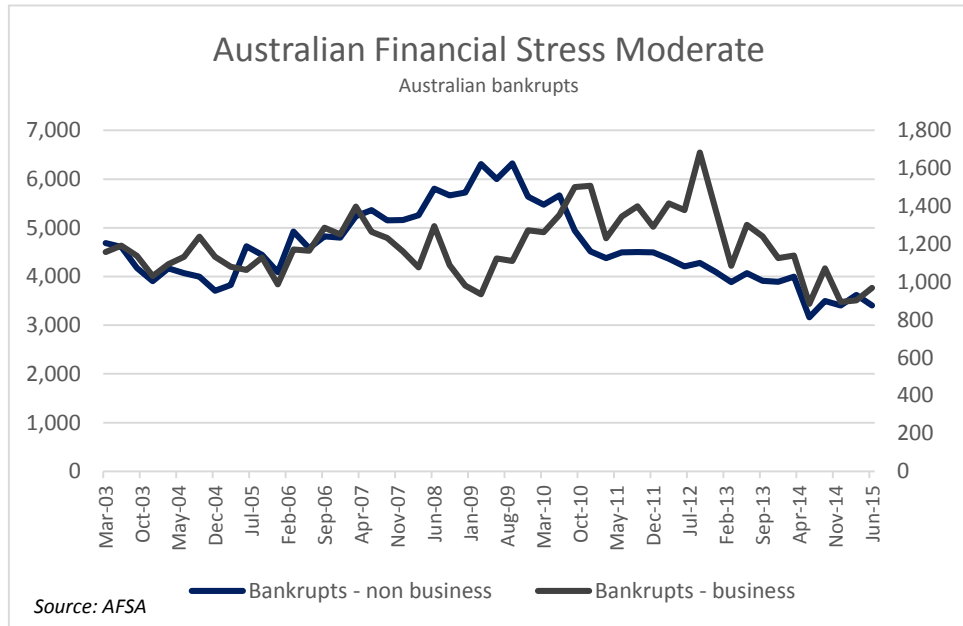
China FX Reserves (SU\$ b)



Sources: Spectrum, Thomson Reuters

Looking forward

Spectrum sees overall AUD credit spreads remaining well supported over the coming twelve months. We foresee corporate defaults remaining low. This along with the prevailing low interest rate environment and current reasonable value support continued steady returns for the overall credit markets in Australia.



Spectrum Asset Management manages the EQT Spectrum Credit Opportunities 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>

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