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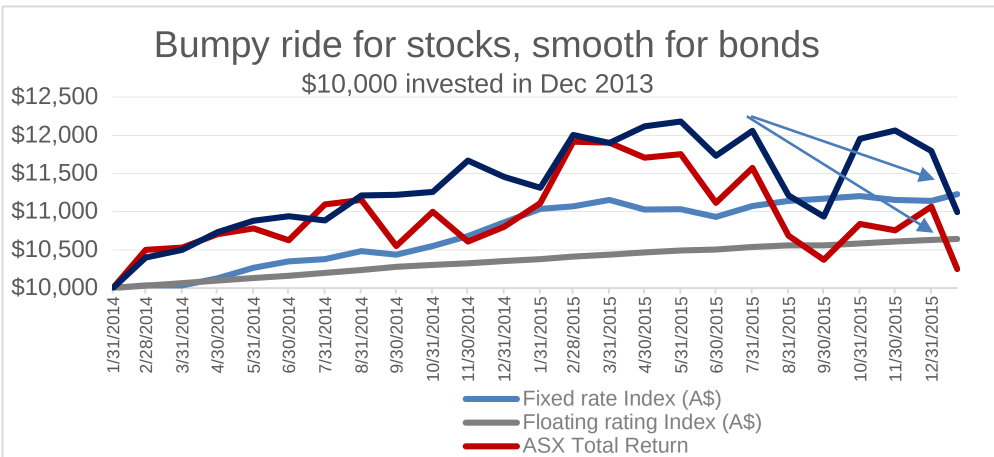
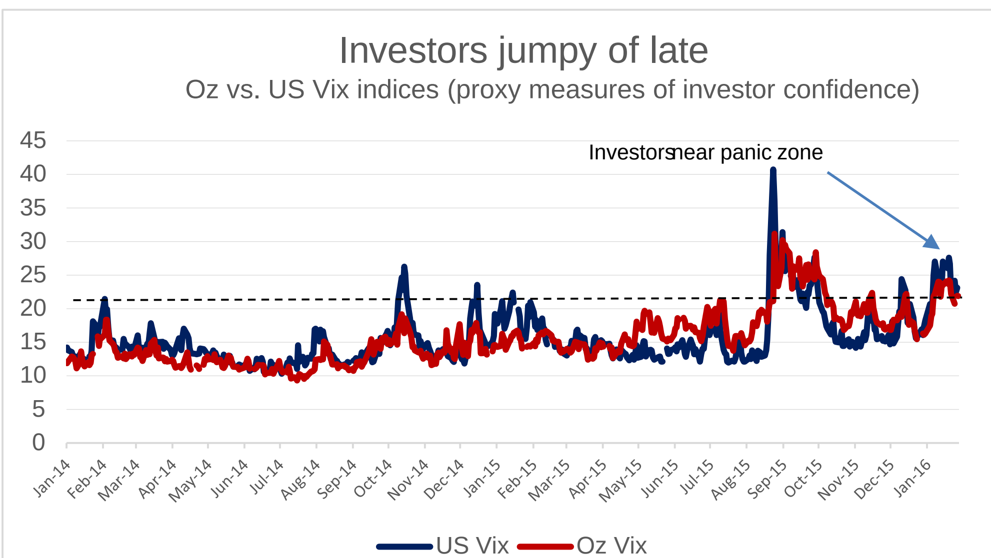
Commodity Crunched? Try A$ corporate bonds

When markets are in extreme fear or greed mode, new selling or buying can have an outsized impact on prices. Right now, many markets are near panic mode. We believe the reported selling of assets by Sovereign Wealth Funds (SWFs) is contributing to the scale of the plunge. The driver of SWF selling is linked to the collapse in commodity values and in particular oil prices. As a sustained recovery in commodity prices may not come soon, this investment 'crunch' may recur. Not all asset classes are being hit as hard, though. As the graph below shows, A$ corporate bonds have performed reasonably well since mid-December 2015. The sound credit fundamentals, values and an absence from offshore selling underpins sustained solid, albeit, bumpy returns for 2016.



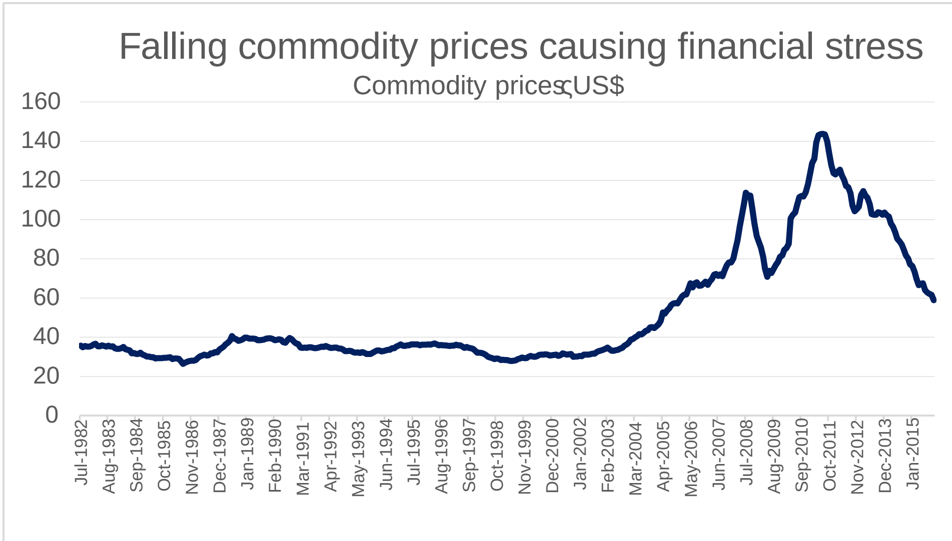
Source: Spectrum, Reuters, S&P



Sources: Reuters, Spectrum

The problem facing commodity countries

Sovereign Wealth Funds (SWFs) around the world were set up mainly to store wealth in the good times so they can help buffer economies in the bad times. For commodity-dependent economies, the bad times are now.



Sources: RBA

For example, crude oil prices have fallen around 50% over the last 12 months and are arou two-thirds of where they were in 2014. This general fall has caused fiscal problems for som commodity-dependent countries. Expense budgets were premised on far higher commo revenues. For example, Saudi Arabia was generating budget surpluses of around 14% of GDP in 2012. This strong position plummeted to a fiscal shortfall of around 20% in 2015.

The solution for SWFs, sell what you can

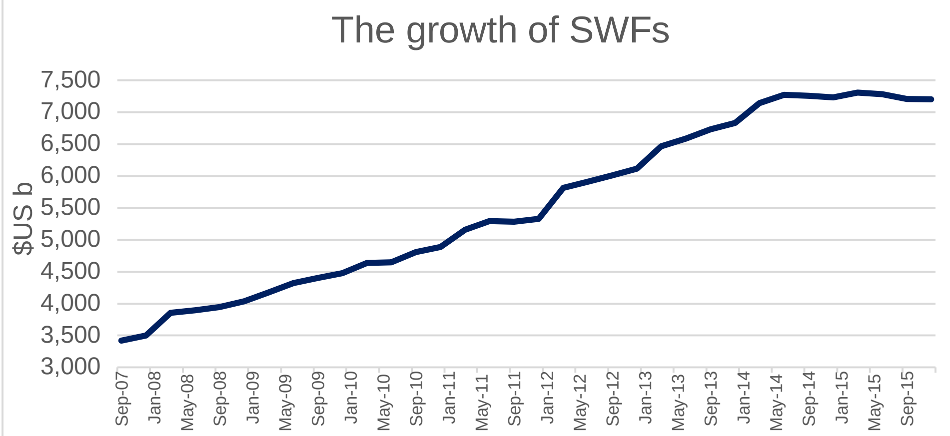
Fiscal holes have to be financed. One way is to issue bonds. This is becoming increasingly challenging for some countries as emerging market and commodity-linked credit spreads widen. The other way is to tap savings. Or, in other words, sell the assets in SWFs.

SWFs typically have investments in a range of risk assets, for example, infrastructure, private equity, corporate bonds and listed equity. When the need to sell comes quickly, you sell what you can. Tradeable securities such as listed equity and corporate bonds are among th easiest to liquidate. Prices and valuations are not overly important. The main goal is to cash.

JP Morgan estimates that at oil prices of $US31 SWFs will decline by $US140b in 2016. Breakingviews takes a more bearish tone. It estimates that Middle Eastern countri will need to liquidate around US$200b in assets if oil averages $US35 and around $US500b assets if oil falls to $US20 a barrel.

The impact of SWFs – hard to ignore

As seen in the graph below, SWFs have grown susbtantially in recent years. They currently total around US$7t (A$10t) or the equivalent of around six times the total market capitalisation of the Australian stock market. Collectively, they can have a notable influence on global market prices.



Sources: Sovereign Wealth Institute. Note these include estimates and data is not updated from original sources regularly

Compounding the problem of SWF sales in recent times were the following:

- U.S Mutual Funds alone have seen huge outflows of around $US 100b over the last quarter of a year;
- U.S economic data were disappointing;
- were plummeting; and
- Many investors were on leave, leading to reduced market volumes.

Looking forward, should commodities, in particular oil, prices remain at near or below current levels, more SWF selling of risk assets is likely to follow. The scale of this impact will be dependent on the power of other variables. At best, it will be a head wind. At worst, it will compound negative news.

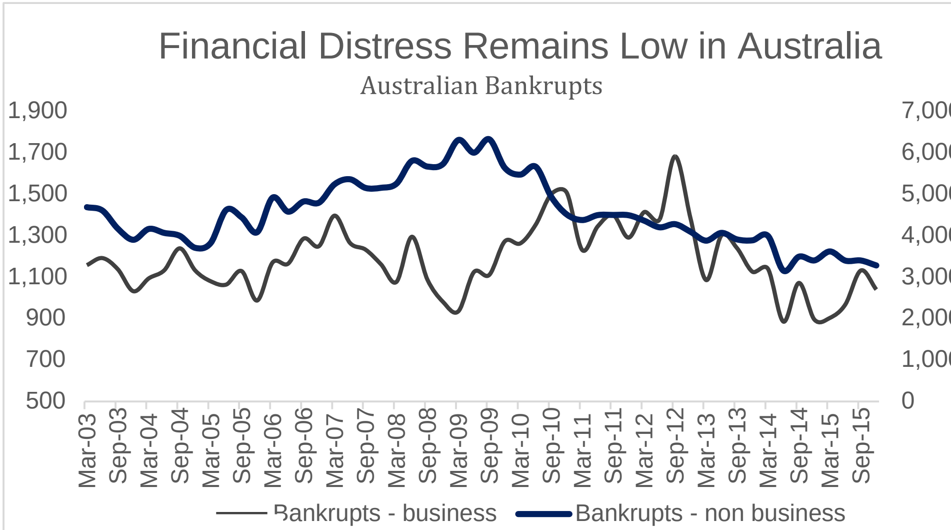
The fundamental credit reality – not that different

Recently apocalyptic forecasters have proclaimed that the financial world is on the precipice of collapse. These Doomsayers are having their 15 minutes of fame. We note they only typically get media oxygen when the financial markets are very weak. Often, they have been spinning a similar line for several years.

Spec... world is not about to end. There is no imminent financial system collapse in any major economy. Nor is any developed country sovereign likely to default.

Certainly, there are problems specific to the credit markets. Corporate default rates in the U.S. and emerging markets are poised to move notably higher over the next year. The sub sector most at risk are second tier commodity producers. Spectrum believes the default rates will go far higher but be reflective of a typical credit cycle and not result into anything like what we saw in the 2008 GFC.

In Australia, too, we expect financial distress to rise. This, however, is from a very low base. Bank bad loans are at near zero. Bankruptcies are low as well. Second tier commodity companies and commodity service companies are set to face more financial stress. Marginal property developers, too, could hit the skids as residential unit property price growth stalls. Widespread financial distress, however, does not look to be imminent.



Source: AFSA

More importantly most A$ corporate bonds issuers have sound balance sheets and ar with withstand and adapt to negative influences.

Global danger, local safety

Ultimately, price changes are driven by flows. These flows stem from liquidity, value assessment, fear, greed or need. ƚ ÿ Ř λ ű Ω for SWFs to sell that appears to be havin a larger than usual influence on price movements of late. Presuming commodity prices, in particular oil, remain at near the current levels, global risk assets may face more forced sellin from SWFs. Australian investors in risk assets are unlikely to be completely immune from this.

All is not bad though. We wrote in our [2016 A$ corporate bond outlook]() that we expect hard-earned but decent returns for A$ credit investors in 2016. We maintain this view. A$ corporate bond defaults should be low and investors are getting well-compensated for default risk, in our view.

To help preserve capital and reduce volatility while generating attractive returns, Spectrum believes in keeping a large portion of corporate bonds in short-dated securities from high quality issuers will go a long way to achieve this in 2016.

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