



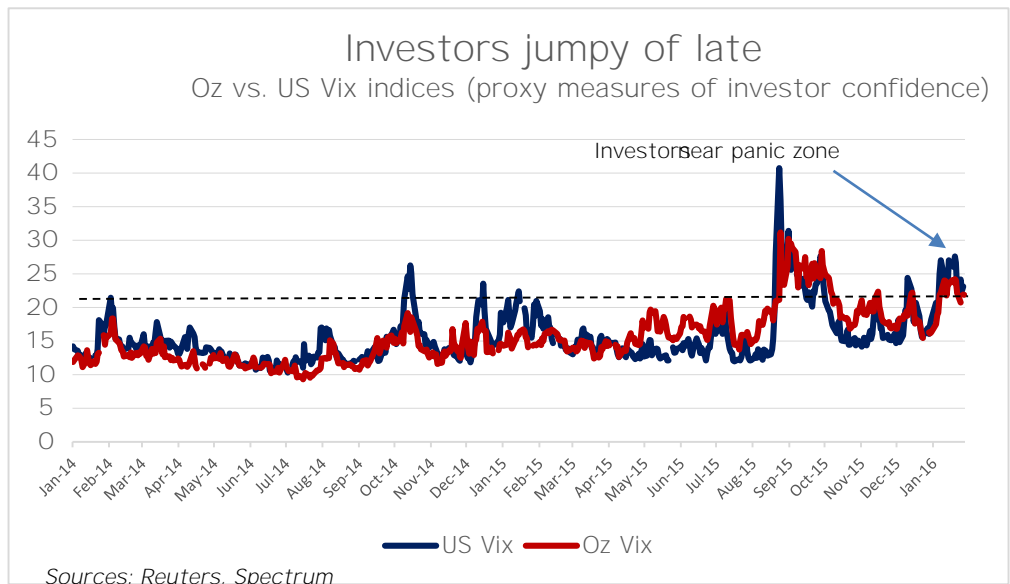
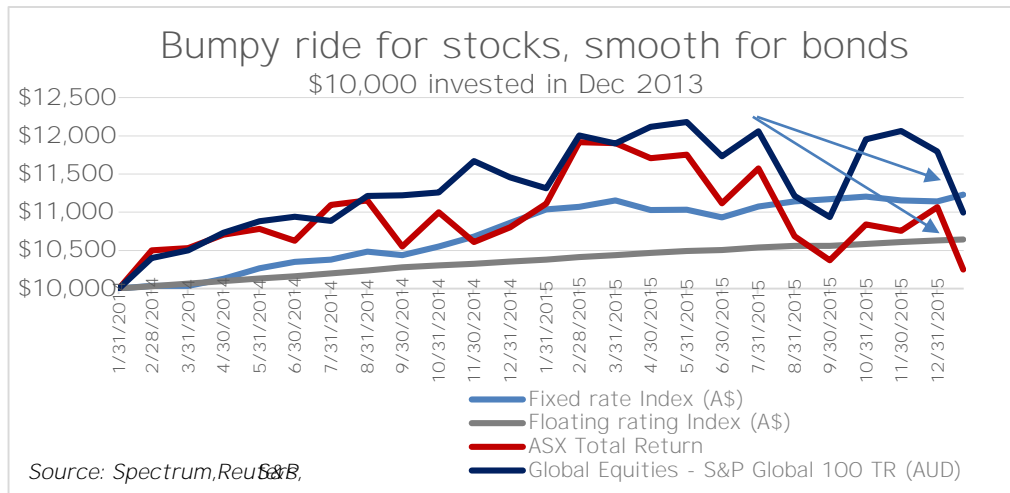
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# Spectrum Insights

JANUARY 29, 2016

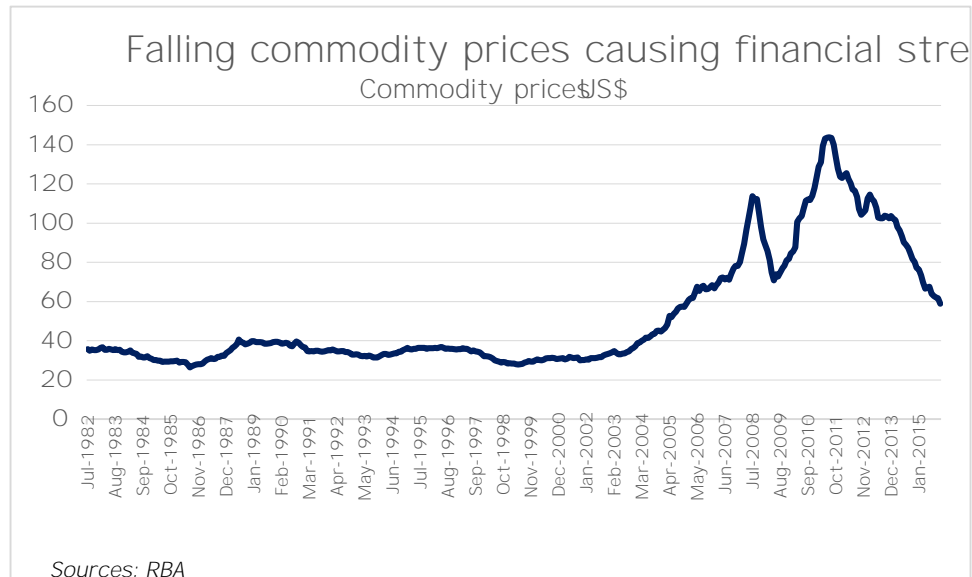
## Commodity Crunch? Not for \$ corporate bonds

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



The problem facing commodity countries

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



For example, crude oil prices have fallen around 50% over the last 12 months and are two thirds of what they were in 2014. This general fall has caused fiscal problems for commodity dependent countries. Expense budgets were premised on far higher commodity revenues. For example, Saudi Arabia was generating budget surpluses of around 1% 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

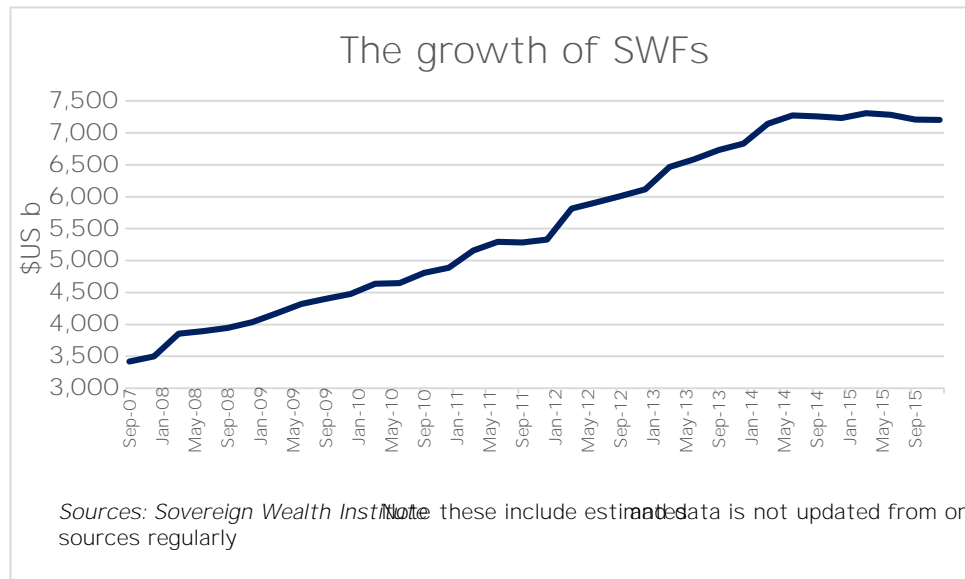
Fiscal holes have to be financed. One way is to issue bonds, but this is becoming challenging for some countries as emerging market and commodity linked credit spreads widen. The other way is to tap savings. On other words, sell the assets in SWFs.

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

JP Morgan estimates that at oil prices of \$US31 SWFs will decline by \$140b in 2016. Breakingviews takes a more bearish tone and estimates that Middle Eastern countries will need to liquidate around US\$200b in assets if oil averages \$US50 a barrel. US\$500 assets if oil falls to \$US20 a barrel.

The impact of SWFs hard to ignore

As seen in the graph below, SWFs have grown substantially in recent years. Currently total around US\$ 7,100 or the equivalent of around six times the total market capitalisation of the Australian market. Collectively they can have a notable influence on global market prices.



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

- < U.S Mutual Funds alone have seen huge outflows of around US\$100 billion a quarter of a year
- < U.S economic data was disappointing
- < # of jobs were plummeting and
- < Many investors were on the lead to reduced market volumes

Looking forward, should commodities, in particular oil, prices remain at near or below 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.

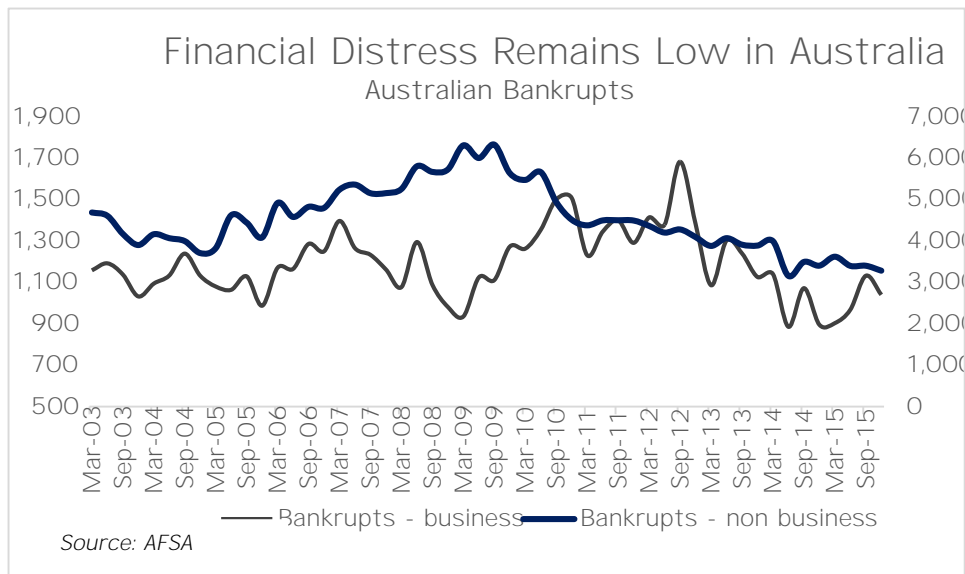
The fundamental credit reality not that different

Recently, apocalyptic forecasters have proclaimed that the financial world is on the precipice of collapse. These doomsayers are having their 15 minutes of fame. Note they often typically get media oxygen when the financial markets take a breather. Often, they have been spinning a similar tale for several years.

Spectacularly, the world is not about to experience a financial system collapse in any major economy and developed countries are unlikely to default.

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

In Australia, too, we expect financial distress to remain low, however, from a very low base. Bank bad loans are at near zero. Bankruptcies are low as second tier commodity companies and commodity service companies face more financial stress. Residential property developers could hit the skids as residential property prices are in a growth stall. Widespread financial distress, however, does not look to be imminent.



More importantly, A\$ corporate bonds issuers have sound balance sheets and can withstand and adapt to negative influences.

Global danger, local safety

Ultimately, price changes are driven by these flows stem from liquidity, value assessment, fear, greed or need. For SWFs to sell that appears to be a larger than usual influence on price movement. Commodity prices in particular remain at near the current, global risk assets may face more forced selling from SWFs. Australian investors in risk assets are unlikely to be immune from this.

All is not bad though. We wrote in our [2016 A\\$ corporate bond outlook](#) we expect to have earned but decent returns for A\$ credit investors. We do not see A\$ corporate bond defaults should be low and investors are well compensated for default risk, our view.

To help preserve capital and reduce volatility while generating attractive returns, we believe 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.



