



Damien Wood, Principal

# Spectrum Insights

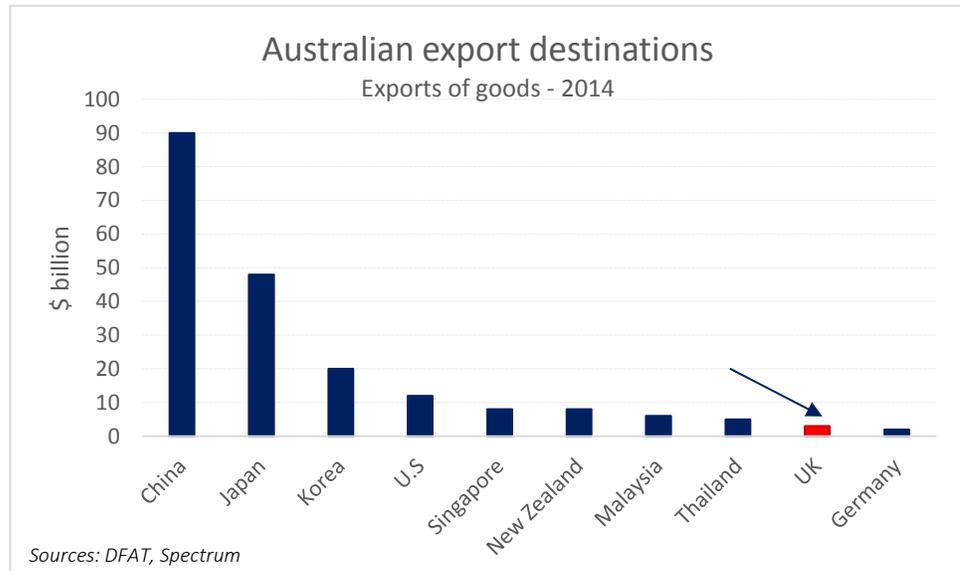
JUNE 27, 2016

## Brexit – keep calm and carry on in A\$ corporate bonds

Brexit means uncertainty. Uncertainty on its impact on the UK economy and uncertainty on whether it sets a precedent for others in the EU. And investment markets do not respond well to spikes in uncertainty. But what does it mean for Australian corporate credit risk? Next to nothing. Earnings and debt levels will barely, if at all, change due to Brexit. If A\$ corporate bonds weaken notably as a result of Brexit, it improves their value. Investors should get ready to take advantage of this.

### Why little fundamental impact?

Of all Australian exports, only around 2% goes to the UK. This equates to around half a per cent of Australia’s annual income or GDP. Hence, it would take a monumental cutback in demand from the UK before it could make a notable impact on Australia’s economy.



### Contagion – the bigger risk

Other EU members may now seek to exit as well. That would create further uncertainty in the economic outlook of a far bigger share of global economic output. The most worrying aspect of this for Australian investors is continued widespread volatility in global financial markets. Australian assets are unlikely to be immune.

One scare to the bond markets has come rather quickly. Ratings agency S&P has already announced that “a (U.K) AAA-rating is untenable under the circumstances”. Other UK

bond issuers may suffer credit rating downgrades as well. The fallout may not be too severe however.

First, it has never been a better time to lose an AAA rating. The current yield-desperate market tends to look past modest credit problems for just a little extra yield. For example, the barely investment grade BBB- rated Italy has a 10 year government bond yield of just 1.55%. For reference, the UK 10 year bond yield fell 29 basis points last Friday to end at a mere 1.08% - hardly a vote of lost confidence in the UK's credit standing.

Second, if the problems spill over into the wider EU corporate bond market there is now a very ready buyer – the European Central Bank. As we noted in [The yield hunt just got harder](#), the ECB is now buying European corporate bonds. This should underpin the performance of this sector for at least the short term and hence help contain contagion risk to the A\$ corporate bond market.

### Opportunities

As a bond investor, you are ultimately concerned about getting interest payments and then your principal back in full. Next to nothing has changed for A\$ corporate bonds as a result of United Kingdom's departure from the European Union. If A\$ corporate bonds fall due to the uncertainty over a Brexit fallout then that makes them cheaper. At Spectrum, we have entered into the post-Brexit decision with a relatively large cash position of 11% of the portfolio. We are ready to deploy some of this should prices fall notably.

*Spectrum Asset Management manages the Spectrum Strategic Income Fund. This fund invests in A\$ 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>. Spectrum and the author have investments in either securities mentioned in this report or comparable securities*

### DISCLAIMER

- This report has been prepared by Spectrum Asset Management Limited
- (ABN 31 096 442 198, AFSL 225069).
- It is for information purposes only and does not constitute or form part of, and should not be construed as, an offer, invitation or inducement to purchase or subscribe for any securities or funds nor shall it or any part of it form the basis of, or be relied upon in connection with, any contract or commitment whatsoever. It also does not constitute a recommendation regarding any securities or funds.
- The information in this document has been obtained from sources believed to be reliable but no representation or warranty, express or implied, is given hereby as to the fairness, accuracy or completeness of the information or opinions contained herein. This presentation reflects the information available as of the date this presentation was prepared and is subject to change without notice to the recipient.
- Past performance may not necessarily be repeated and is no guarantee or projection of future results.
- This report is intended solely for the information of the person to whom it has been delivered. It is not an advertisement and is not intended for public use or distribution. No part of this report may be reproduced or distributed in any manner without prior written permission of Spectrum Asset Management Limited.