Spectrum Asset Management

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Spectrum Insights

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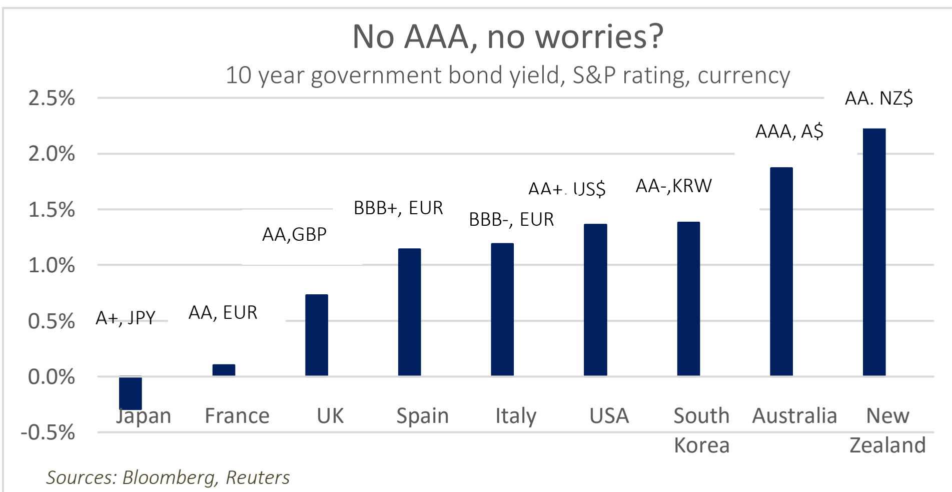
AAA lost – no worries today, concerns tomorrow

The major credit rating agencies are making noises that Australia's prized "AAA" rating is on borrowed time. With apologies to Charles Dickens, we see it both as the best of times and the worst of times if Australia were to lose its reputation as one of the world's safest borrowers.

Never been a better time

The "good" timing stems from the possibility that if the downgrade comes soon, investors are likely to largely shrug it off. At present, the investment world is starved of yield. Around $US10 trillion of sovereign bonds are generating negative yields. For example, the graph below shows the negligible yields of 10 year bonds from countries with lower credit ratings than Australia's.



We note that these markets are supported by larger domestic or currency investor bases. Moreover, some central banks are pushing yields lower by buying sovereign bonds.

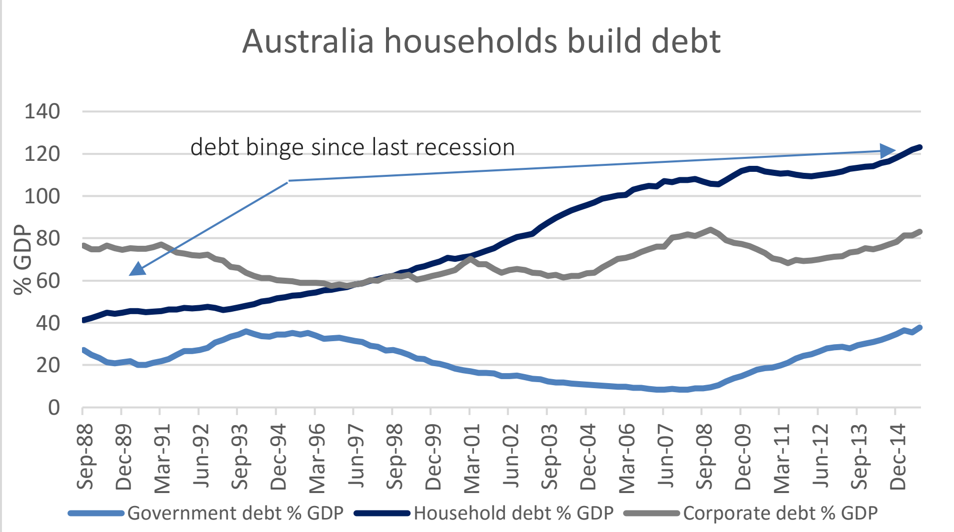
In contrast, the Australia government is reliant on offshore investors for its funding. Foreign investors currently own around 60% of Australia's government bonds.

However, given the absence of yield elsewhere, Spectrum believes a one notch downgrade is likely to have little near term impact on the cost of borrowing for the Australian government or even our banking sector.

Longer term, though, rating downgrades pose some key risks.

Never been a worse time

The risk of a sovereign rating downgrade comes after 24 years without a recession. If the Australian government is struggling to balance its books now, how will Australia's fiscal position look during tough economic times? Unless structural changes are made in the government's finances, more downgrades could follow should Australia's record run of economic growth hits a wall.



Sources: BIS, Spectrum

Why it matters – the banks

Australia's banks borrow around $600 billion from abroad. A key concern many foreign investors have about Australia and its banks is the continuous climb in housing prices, financed, since the last recession, by rising household debt. To some, it looks like a bubble. Despite this concern, investors often take comfort that the Australian government has the will and capacity to financially support our major banks should the need arise.

If either the sustainability of Australian housing prices or the ability of the sovereign to support banks become less certain, then sustaining the $600b in funding could become challenging.

It's not the cost that's the concern

The increase in borrowing costs resulting from a sovereign and bank rating downgrade is the easy part for banks to handle. Banking in Australia is a cost-plus business. Customers will wear most of the early pain.

The real risk lies in the fact that it will make it more difficult for banks to refinance. The remote worst case scenario is some or all banks would be at risk of a liquidity crisis. This is the Achilles heel of the financing structure of the Australian economy.

AAA – an insurance policy

The next time you read or hear a market commentator dismissing the importance of a rating downgrade look at their time frame. The risk is down the track. The time Australia needs a triple AAA rating is like the time you need insurance for your home – when your house is at imminent risk of destruction. Likewise, if our economy and banks are in trouble, the fall back insurance of a sovereign AAA rating would be very handy to have. Not only would it help ease foreign investor concerns about our banks, it would give the government flexibility to stimulate the economy through more spending.

For example, this insurance was used during the recent GFC. Bank access to funding was a challenge for many banks around the world. Then the government played its AAA card, gave banks access to its highest rating via guaranteed debt and fears about the local banks eased soon after.

Investment implications

Each decline in Australia's sovereign rating makes it marginally riskier to invest in Australia's corporate bond market, in particular, bonds from banks. At present, the Australian government has the flexibility to address its structural over-spending. In the meantime, we will keep a keen eye on the risk of a recession and sovereign downgrades happening at the same time. As this risk rises, a sharp reduction in our exposure to the Australian banking sector will be reviewed.

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