SPECTRUM ASSET MANAGEMENT

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Spectrum Insights

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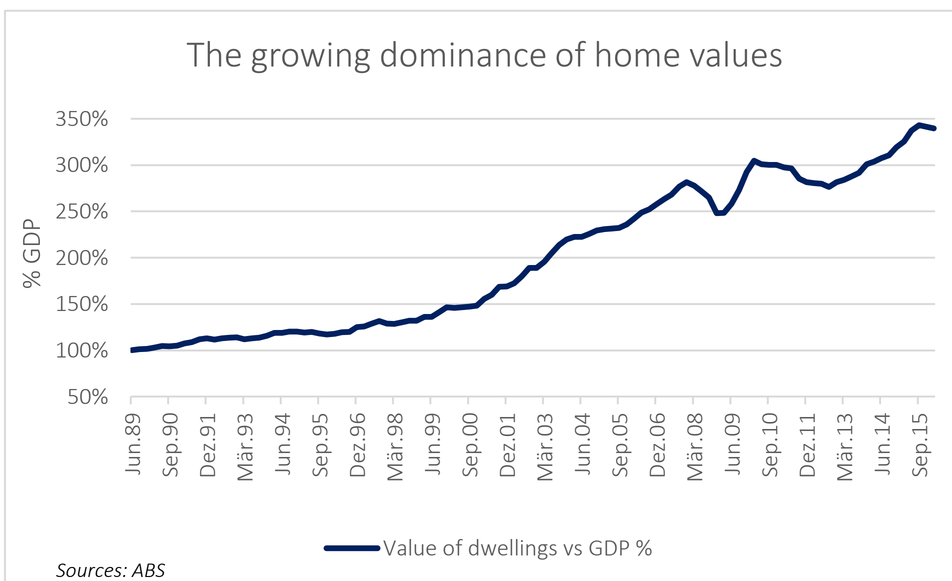
What a waste of debt

Debt can do economic good - that is, if its proceeds are put to productive use such as infrastructure or education. However, Australia's debt binge since our last recession has gone largely towards rising home valuations. This debt not only has little long term economic benefit, it has made the household and banking sectors less resilient to an inevitable economic downturn. Already the rating agencies are warning of a sovereign downgrade – and we haven't even had a recession! The economic growth challenges Australia faces are rising. We, however, take some solace in the fact that Australian businesses are only moderately indebted. This means corporate bond default rates should be modest in the medium term. This and the additional returns investors can get over deposits continue to make A$ corporate bonds look relatively attractive.

Some perspectives on house values and debt

Whether Australian homes are too expensive or not is a hotly and widely debated subject. Spectrum will not weigh in on this debate here. What we do know is that housing values have surged relative to the size of the economy. As the graph below shows, the total value of Australian dwellings increased from around one times the annual national output to around three and half times over the last twenty five years.

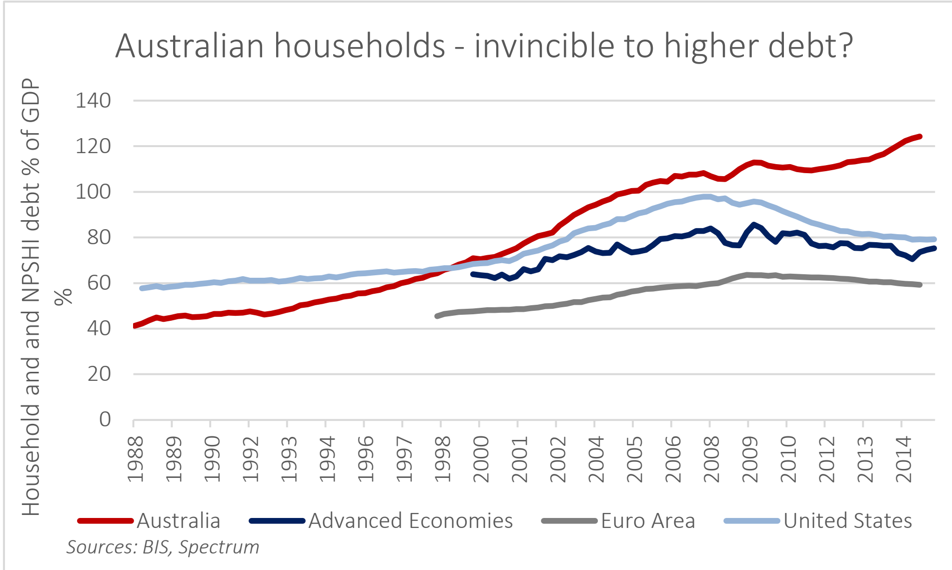


Sources: ABS

Do these dwelling generate three and half times the benefit to the economy as they did in the late 80s? No. They simply do the same job – perhaps in more comfort and style.

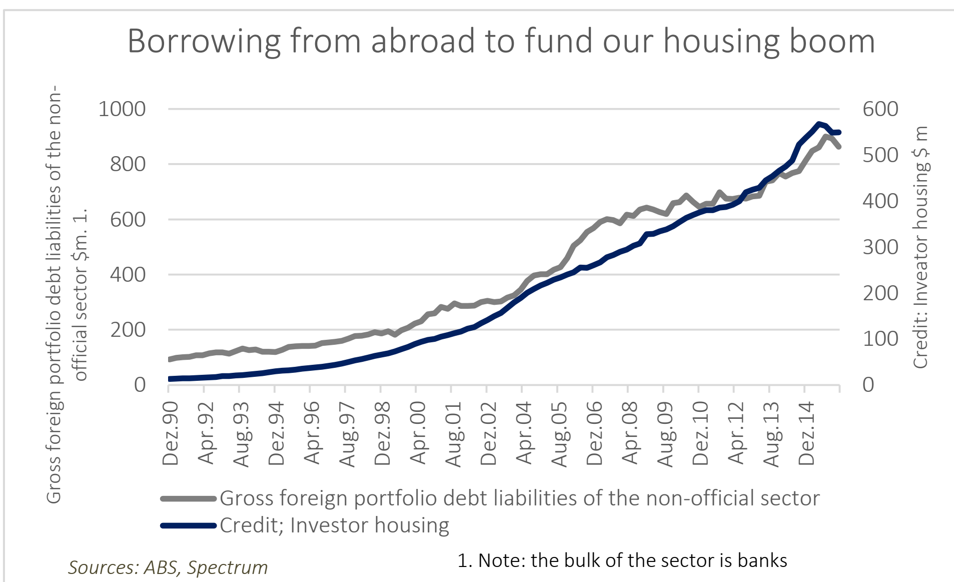
This increase in value is not necessarily a problem. What does concern us is that much of the increase in value appears to be driven by rising household debt.

As the graph shows, Australian households are leveraging up so much that they make others around the world, including American households, look frugal.



Stretching the limits

Part of the boom in home dwelling prices in Australia was driven by investors. As these investors took on more and more debt, they stretched the capacity of the Australian banking sector to lend to them. Relying on the local depositor and bond market was not enough to cope with demand. Banks had to go overseas to plug their growing balance sheet gaps.



Today's circa $600b in foreign bank debt is not an immediate problem. Right now, the major banks enjoy the implicit government support from a "AAA" rated government. In addition, the property market is buoyant and business default rates are very low.

The problem lies in the possibility that the positives noted above can all turn to negatives at around the same time. If so, at best, this will cause an increase in relative funding costs for the banks. At worst, it could cause severe liquidity challenges. Ultimately, liquidity is what determines a bank's survival. Hence, these issues are not trivial concerns.

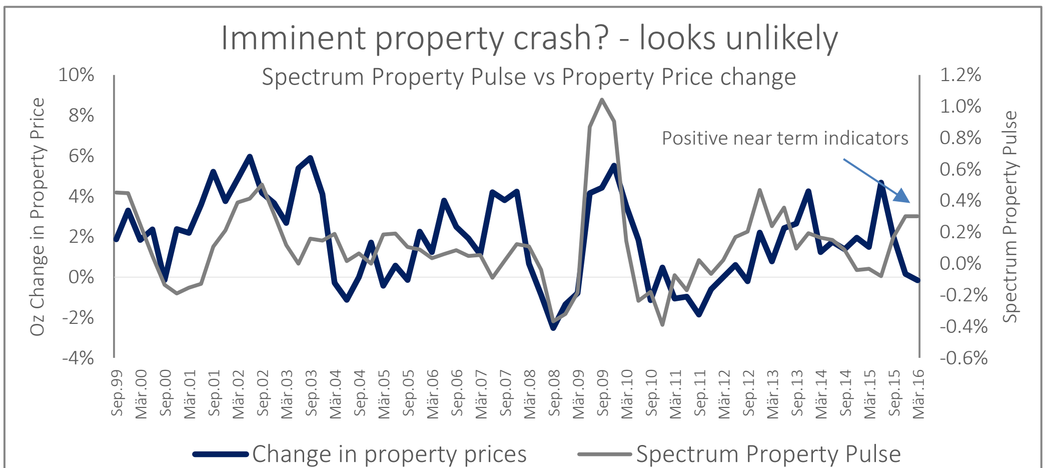
Higher risk with no long term benefits

The Australian housing boom has left the nation with modest additional long term economic benefits but with a banking system laden with foreign debt and a household sector with near world record indebtedness.

Australia Inc. is now starting to push up against debt limitations. Our "AAA" rating is reportedly at risk. Home ownership is now heading below 50% of the population due to high prices and banks are near to maxing out on foreign debt.

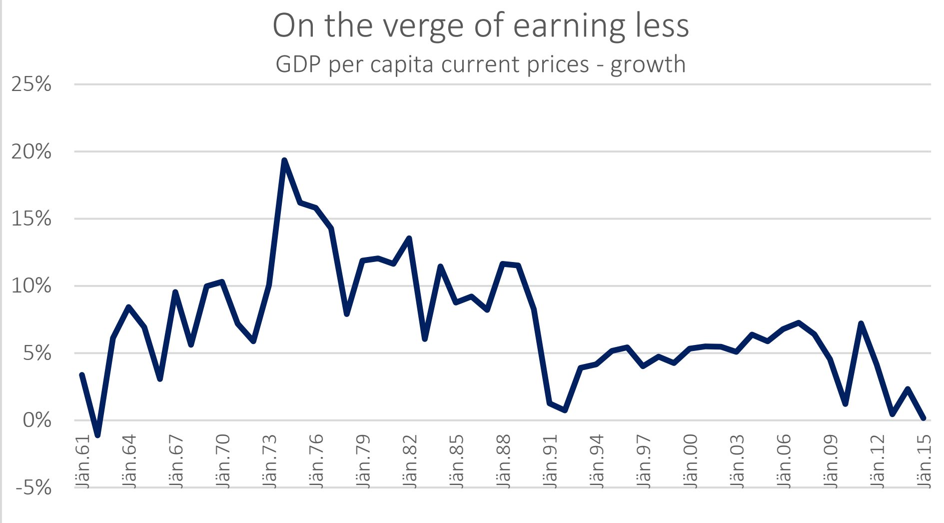
Why would corporate bond investors care?

Australia's economic health now looks highly sensitive to home prices. At Spectrum, we believe that if you do not have a view on the direction of Australian residential property prices, you will struggle to have a considered view on the A$ corporate bond market. Hence, we created and maintain the Spectrum Property Pulse. Right now, there is no indication of a rapid fall in Australian housing prices. Should this change, we would consider changing the risk profile.



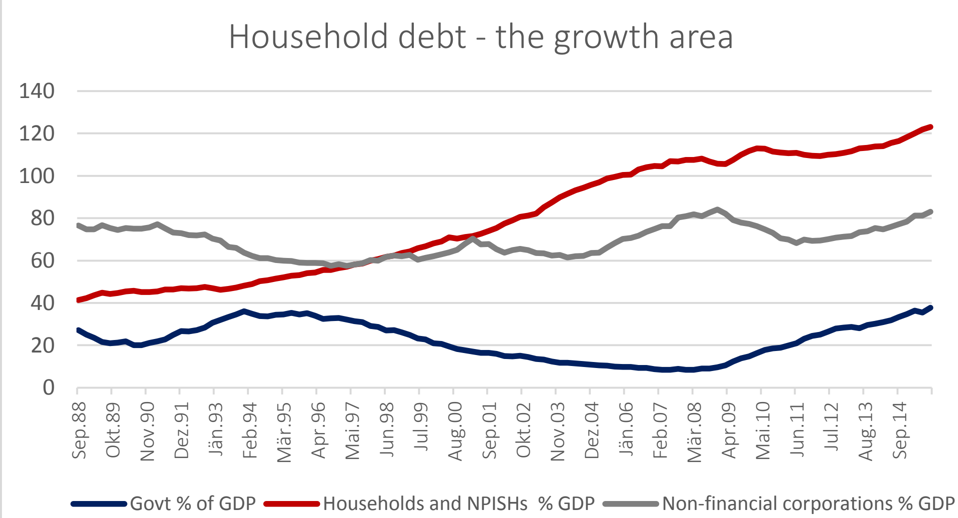
Sources: Spectrum, ABS

The economic plus of the housing price boom is that it spurred on activity in the construction industry as well as their related property service sectors. Combined, this helped smooth out the fall-out from the end the of the post-GFC commodities boom. But this debt fueled buoyancy may be running out of steam. For example, when one looks at graph below, it shows real GDP per capita – or how much we earn after adjusting for prices – is on the verge of contracting for the first time in many years.

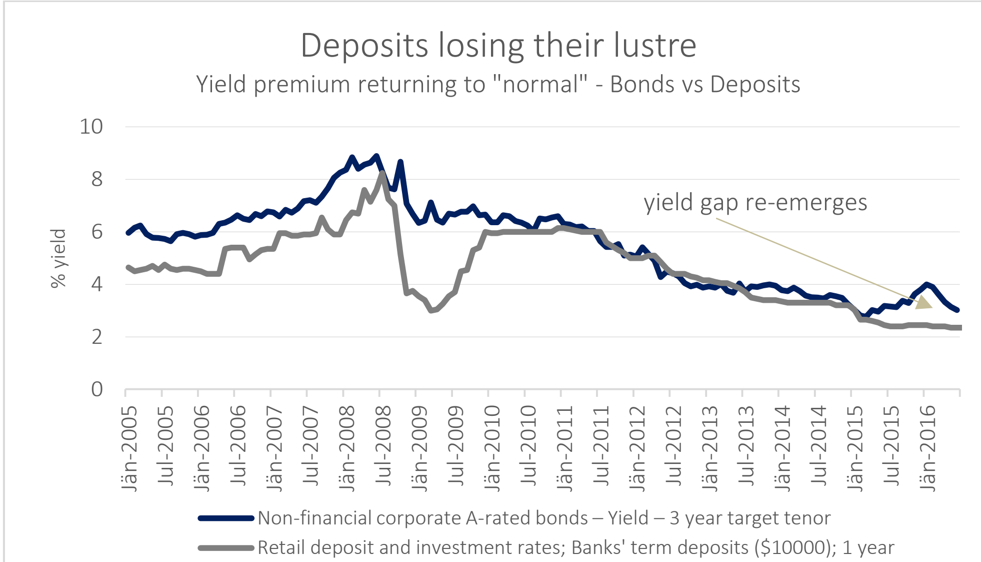


Sources: ABS

Had Australia Inc. used the proceeds of the increased debt and invested in productive assets, we could be reaping the benefits for years to come. We are now post the mining boom and possibly near the end of the property boom. What happens should debt levels start to shrink? What happens when the stimulus from interest rate cuts peter out? Economic prosperity for Australia is looking increasingly challenging in the medium term. A$ corporate bonds now look like a reasonable option in protecting capital while generating income for investors.



Sources: BIS, Spectrum



Sources: RBA, Reuters

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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