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# Spectrum Insights

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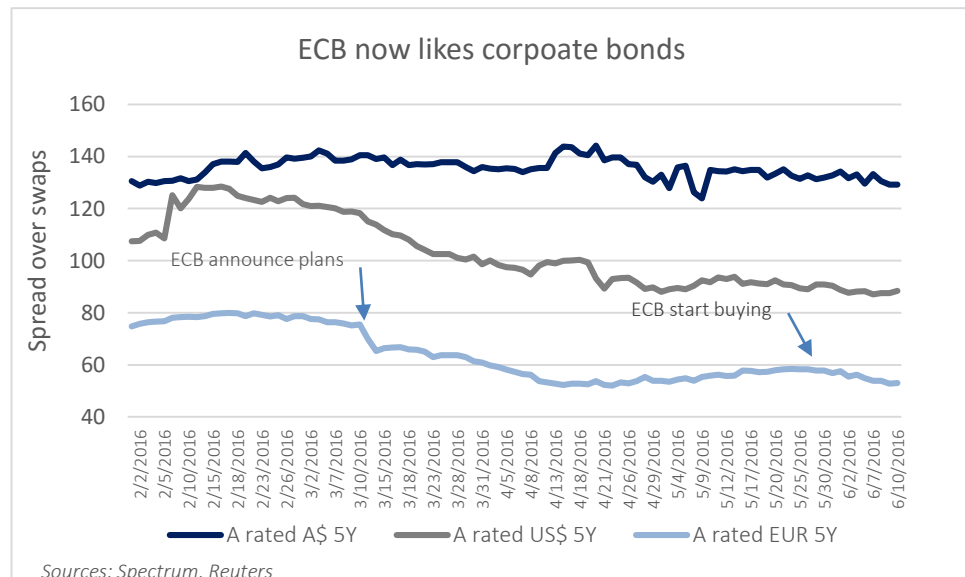
## The yield hunt just got harder

The European Central Bank (ECB) has just started buying corporate bonds in Europe. This has lowered the yields of this target bond group, thereby pushing up bond prices. But what does it mean for A\$ corporate bonds? These too will eventually feel the positive price impact of policy intervention and a global scramble for yield. Fortunately, A\$ credit spreads are still one of the widest in the developed world – despite a relatively benign default outlook. Hence, there is still value in the A\$ corporate bond sector – unlike other parts of the world.

### Background

The ECB continues the modern central bank fad of ultra-loose unorthodox policies. The aim is to stoke inflation and economic growth in Europe. Its newest trick is to buy corporate bonds. The ECB announced plans to do so in March 2016 and started buying bonds this month. The volume is unknown but some analysts are reportedly anticipating €5 to 10 billion a month. This amount would be large for the eligible market of around €600 billion and could take up much of the annual issuance of the market.

Like us, you too may not understand how this bond buying exercise will help the European economy. But that is not our immediate focus. What it will do and has done is help the performance of European corporate bonds. For example, see the recent fall in “A” rated Euro denominated yields since the announcement.

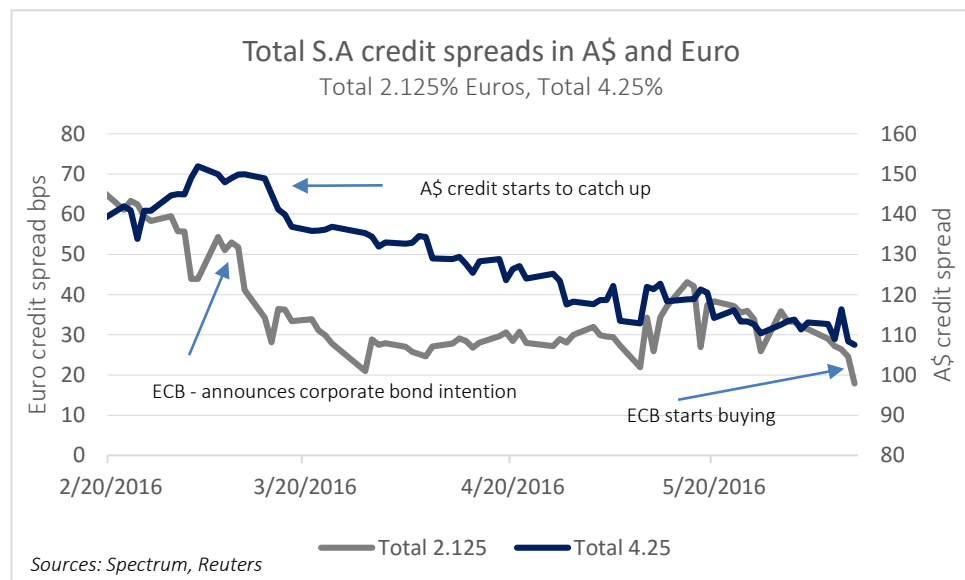


## Why it matters to the A\$ bond market?

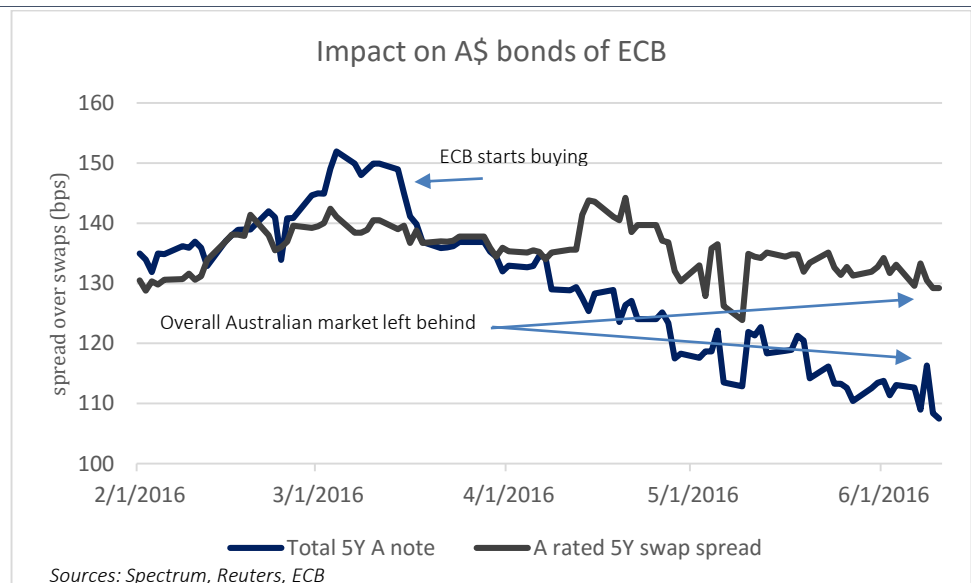
At face, one may not see the direct connection between our corporate bond market and Europe's. The corporate bond market, however, is global at the fringes. There are many bond fund managers who scan the globe for ideas. Many are driven by relative value. And, if the ECB buys up a group of bonds resulting in higher prices, it may make those neglected but similar bonds look relatively attractive. Hence, relative value investors will buy up and narrow the value gap between what the ECB buys and comparable bonds.

## How it squeezes yields elsewhere - an example

*Step 1.* ECB announces it will buy corporate bonds. This includes "AA" rated European corporate issuers such as the French oil giant, Total S.A. The market anticipates the buying and pushes down the additional yield over the government bond yield, otherwise known as the credit spread, on its Euro denominated bonds. Then, investors identify that they are able to buy Total S.A in A\$ at a far higher credit spread after swapping the notes into Euro. This new demand pushes down the credit spread of the A\$ bond.



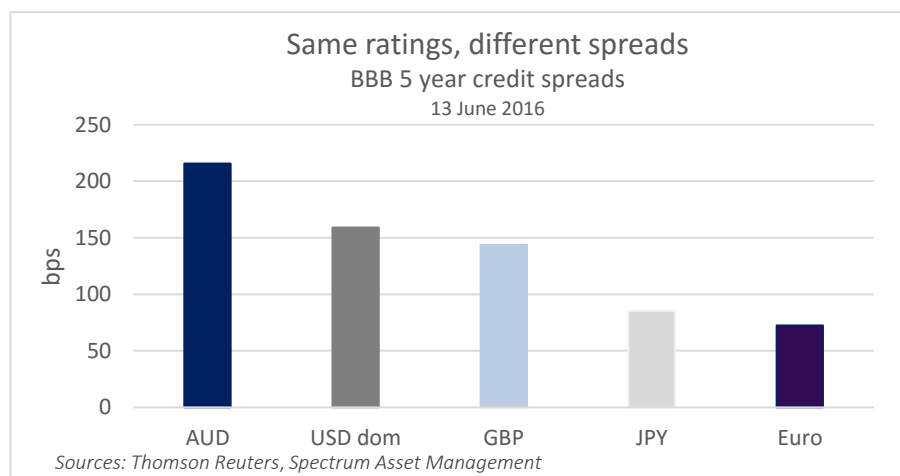
*Step 2.* The remaining investors in A\$ Total S.A then see these as expensive relative to the rest of the A\$ market. They then switch out of A\$ Total S.A into better value A\$ notes, increasing demand for them, thus putting downwards pressure on their credit spreads.



### The quest for yield is global

There are reportedly around A\$10 trillion worth of bonds with yields below zero. Most are from sovereign issuers. This result is largely due to the highly supportive monetary policies of the ECB and the Bank of Japan. Now that the ECB is buying corporate bonds, the yields of this sector are starting to disappear as well. Hence, the global hunt for yield has the scope to intensify.

When scanning the world for value A\$ bonds' credit spreads are now relatively attractive when compared to other markets around the world. The graph below shows the additional yield BBB corporate bond investors get over a risk free benchmark in various currencies. Please note that 100bps equals 1%.



## Blue sky for A\$ bond investors? – not quite

The support for corporate bonds from central bank intervention has and is likely to continue to help the performance of many corporate bond markets. But there is one key element hanging over the corporate bond sector. Rising global default rates.

As we have noted in previous *Spectrum Insights*, rising global corporate bond defaults usually have a negative impact on credit spreads in the Australia. Many of the default candidates are commodity linked. The recent recovery in commodity prices has eased default pressure. Should commodity prices begin to plateau or even fall again then we suspect default risk will get more attention from corporate bond investors. And then credit spreads may come under pressure to widen.

## Spectrum's balanced view

Spectrum sees strong countering global forces at play in the A\$ corporate bond market - the grab for yield vs. rising default risk.

To take advantage of the global grab for yield, Spectrum has a large weighting in "Kangaroos". These are A\$ bonds issued by foreign companies. We believe these are more likely to be early targets of global relative value hunters.

On the other hand news of rising global defaults, in particular in from the U.S, may soon regain media attention. If so, this is likely to put pressure on credit spreads to go higher in parts of the A\$ corporate bond market. To be ready for this possible trend we are currently maintaining high cash levels.

*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*

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