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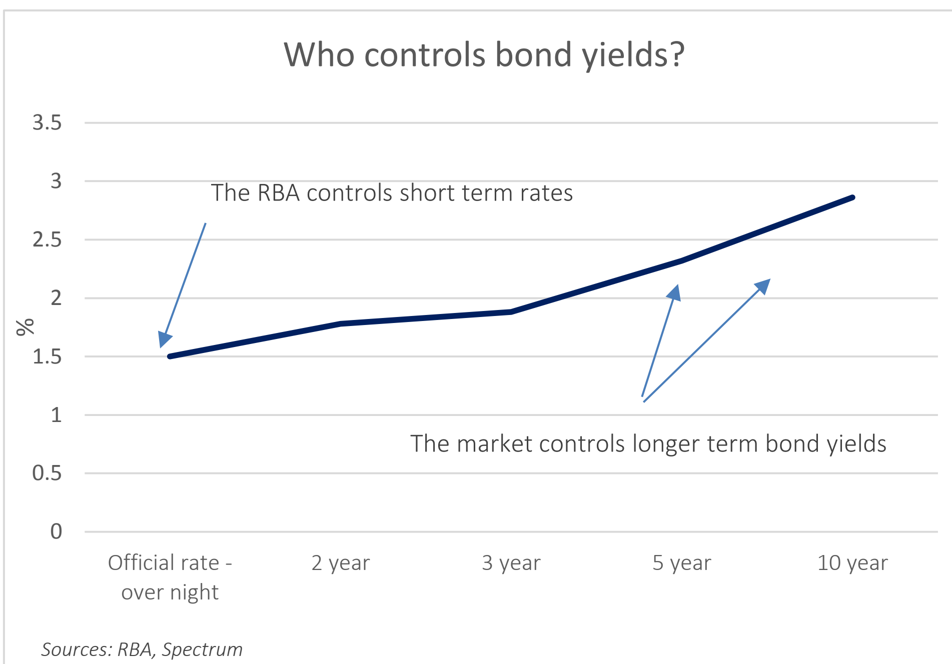
The worst of both worlds

Australia's RBA has its foot on the accelerator while the global bond markets are tapping on the brakes. Just when Australia's economy could do with some stimulus it faces some headwinds from abroad. Rising bond yields internationally are spilling over into our bond markets. This hurts fixed rate bond prices. It also makes borrowing more expensive. Mortgage stress from within our highly indebted households in Australia is already on the rise. To add to this Australia's "AAA" rating is under pressure and there is a lot to be worried about when investing in a generic Australian dollar (A$) bond fund. At Spectrum we are tackling this by 1) investing mainly in floating rate notes – reducing the impact from rising fixed rate bond yields or falling prices 2) avoiding bonds from issuers that rely on residential property development and 3) tilting our weighting towards overseas issuers of A$ bonds. The aim is to protect investors' capital while delivering reasonable income for 2017.

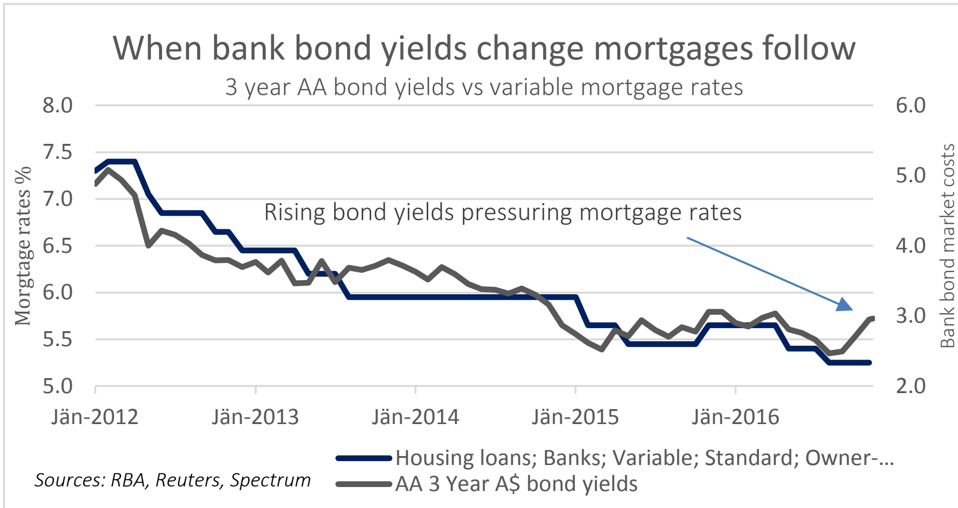
To cut rates, to push on a string

Australia' economy shrunk by 0.5% in 3Q16. Typically in such a situation a cut in official interest rates can ease the pain. While the RBA may choose to lower interest rates, its impact on customers' borrowing costs may be limited. In fact mortgage rates could rise again soon.



Why? The RBA only controls the cost of borrowing overnight. The longer the term of the bond, the more the market sets its yield. As the marginal investor in the A$ bond market is from overseas what happens in the global market place drives our longer term bond yields.

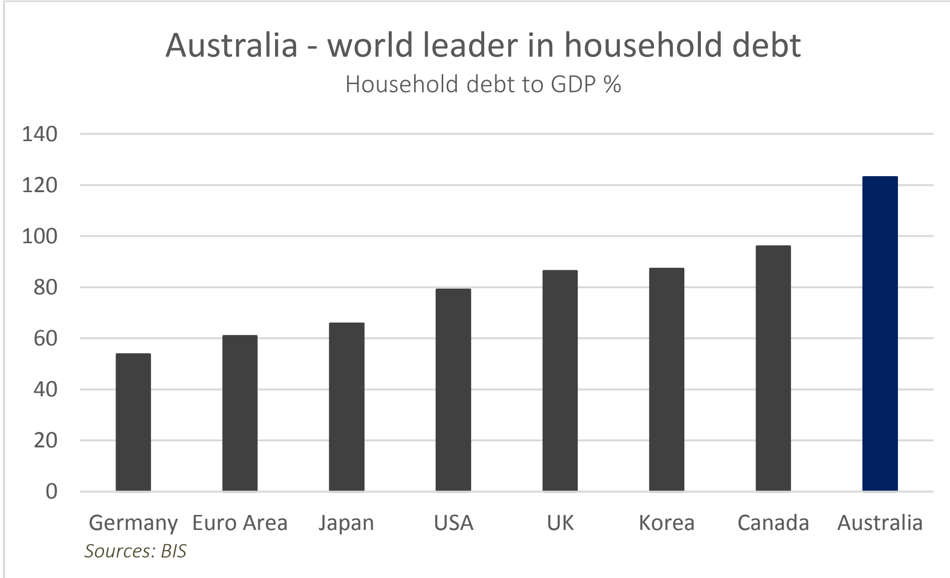
Just as Australian home loan borrowers could do with some relief interest rates are edging up. The reason is Australian banks raise insufficient deposits to fund their loan book. The balance of funds comes from the bond market. Should the cost of borrowing for our "AA" rated banks rise further customers will likely get more hikes on their mortgage rates.

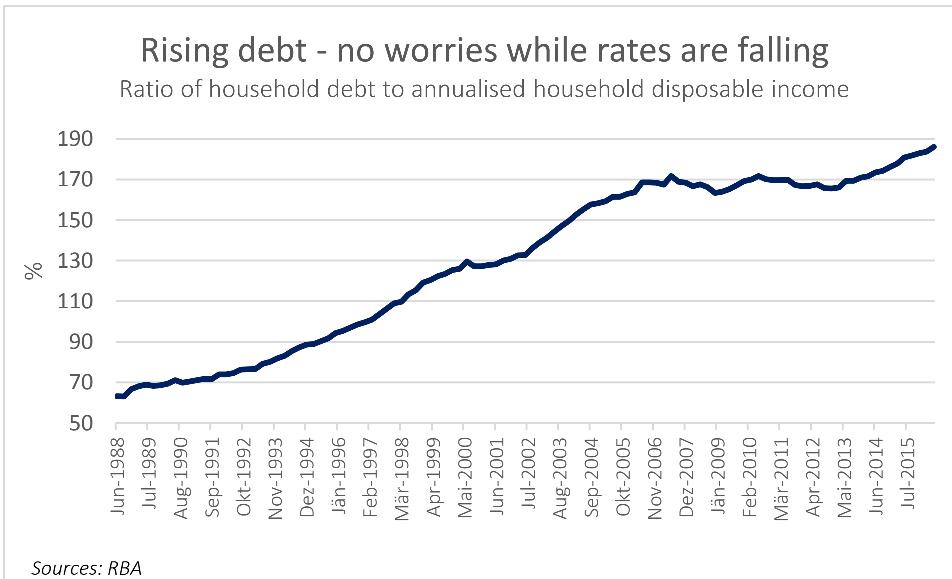


A concern Spectrum has is if the U.S continues to grow at near its current 3% run rate both U.S and Australian bond yields could rise further.

Borrowing while rates were falling was easy

Since the 1980's Australian households have piled on the debt. Much of this has gone into residential real estate. The continuous fall in interest rates and rising property prices created a re-affirming inducement to borrow more. Today, Australian households have world beating debt levels. This makes parts of the sector hyper-sensitive to rate rises. Should the cost of borrowing rise notably from here wide-spread financial stress within Australian households looks set to follow.





Keeping capital protected

At face the case for being cautious on investing in an A$ bond fund has merit. But not all bond funds are the same. A greater reliance on floating rate note shelters investors from global government bond market price gyrations. Bonds from issuers which rely on residential real estate sales or discretionary spending are out of favour. And a growing reliance on A$ corporate bonds from overseas issuers (Kangaroo bonds) helps protect investors from a potential downturn in our own economy.

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.auor contact your mFund brokerhttp://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*