Bonds, Income & Defensive Strategies

Opportunities for higher income

(but you need to be careful)

May 14, 2020

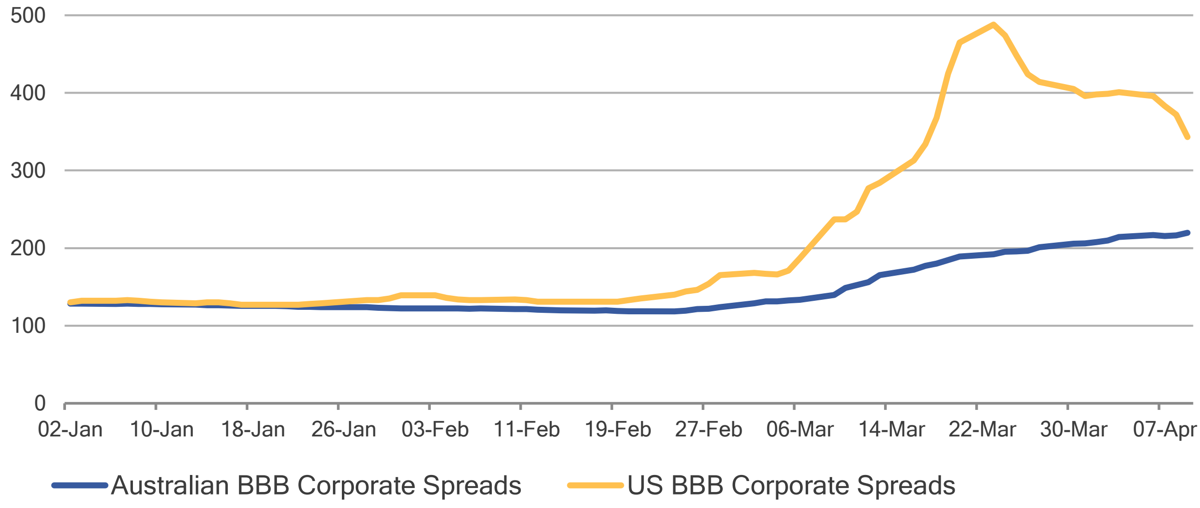
CORONAVIRUS fears significantly impacted credit markets last quarter as virus infections increased across the globe. Concerns about health, GDP and corporate profitability drove risk-off price action across all markets as companies warned of potential negative effects.

In an effort to cushion the virus's impact on economic growth and markets, central banks eased monetary policy further and conducted quantitative easing measures. Governments around the world announced significant fiscal packages (10%+ of GDP) to support employment and stimulate economies. These measures had a positive impact on sentiment – credit and equity markets recovered some of their losses later in the month of March.

Australian credit spreads started to move wider towards the end of February. They accelerated through March following the offshore lead of wider spreads and reacting to an increase in selling into an increasingly illiquid market. In March the RBA stepped in to ease liquidity concerns, setting up a Term Funding Facility to allow ADIs to borrow up to 3% of their outstanding credit to households and businesses at an interest rate of 0.25%. The RBA also announced yield targeting to buy Australian government bonds to keep the three-year yield at 25bps. This saw improved liquidity in most Australian physical markets although there is still less liquidity in corporate names compared to pre COVID-19.

The outperformance of Australian credit indices vs global peers has been interesting. This can be seen in the charts below. This is despite the US central bank announcing direct buying of US corporate bonds via both a primary and secondary market facilities towards the end of March. This allowed companies to issue new debt and enabled liquidity in secondary markets for existing corporate bonds. These announcements saw sizeable rallies (see below).

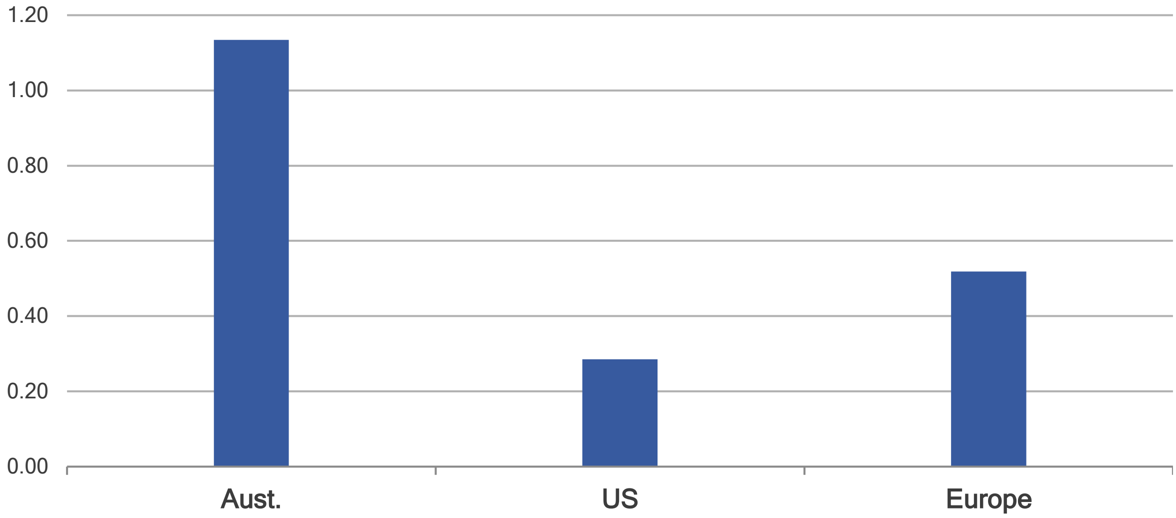
Australia vs US BBB Corporate credit spreads



Source: Bloomberg

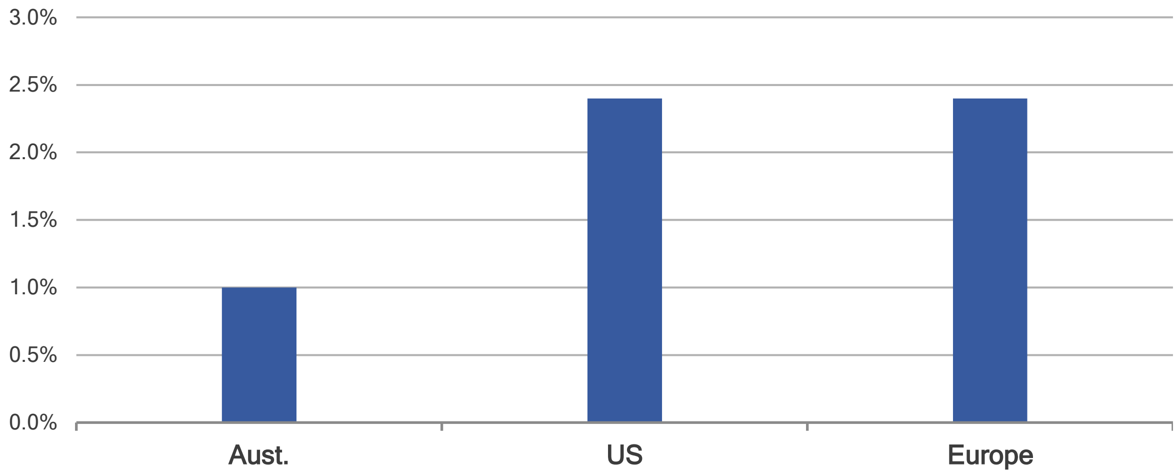
At Pendal we have often said Australian investment grade credit has some of the best risk/return statistics across the globe. It's a great investment for the core of any income solution. As evidenced below, Australian investment grade credit generally has the best Sharpe ratio and the lowest defaults.

Floating credit risk-reward ratios*



*Note: Since common inception June 2004
Source: Bloomberg, Pendal

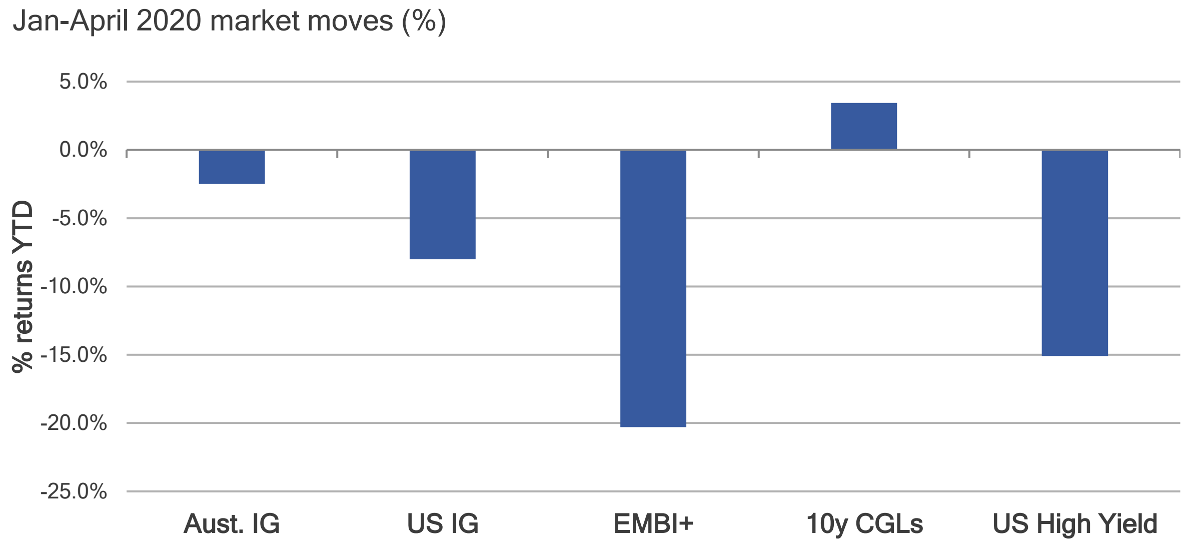
Historic default rates



Source: Bloomberg

There are many reasons why this may be the case. These include the predominance of long-term investors in our credit markets and the lack of depth in the high-yield market here (meaning our companies are very determined to hold onto their investment grade credit rating to protect their capital flows). Since the GFC we have also seen better capital management of Australian companies with concerted efforts to reduce debt and improve balance sheets. This has resulted in much stronger companies able to be more resilient during this recent downturn.

Australian investment grade credit again stood up in the COVID-19 crisis. The chart below shows the lower drawdowns versus other income assets for the first four months of the year – apart from 10-year Australian Commonwealth Government bonds (i.e. Commonwealth Government Loans) which don't provide much income.



Source: Bloomberg

Is now a good time to invest in Australian investment grade bonds?

There are several factors making Australia the lucky country right now. These include:

- Australia's government fiscal policy is one of the world's largest. In direct fiscal stimulus, Australia is spending 10.6% of GDP including the JobKeeper wage subsidy and cash handouts to households and business. That's the highest rate of all advanced economies.
- The virus has been well contained, allowing lock downs to ease in coming weeks. Due to an early shutdown and natural barriers, the Australian economy may recover more quickly than offshore economies.
- Australia is more likely to hold our high credit rating because of a strong fiscal position before the downturn and continued fiscal spending in key areas such as infrastructure to aid recovery.
- Australian companies and banks have stronger balance sheets now than in previous downturns. Lessons learned from the GFC have seen less debt on balance sheets, better long-term funding of companies as well as strong capital ratios in our banking system. This supports Australian corporate borrowing at lower rates as well as minimising defaults.

Where to look for opportunities?

Investors eyeing corporate bonds in this uncertain economic outlook need to ensure resilience in credit profiles. It's important to ensure companies have strong balance sheets. Line of sight to revenue sources and appropriate capital allocation decisions made to protect bond holders during the crisis is also critical.

Infrastructure, utilities and senior bank debt are among the key areas we are investing in.

In Utilities we have (and continue to buy) corporate bonds in electricity and gas distribution. These are highly rated companies that are typically privately owned by superannuation plans, sovereign wealth funds, CKI and Singapore Power.

In the current turbulent environment these are among the companies most resilient to changing economic activity. Most of their revenue (greater than 90%) is underpinned by a regulated tariff structure enabling them to earn a certain agreed return over a period, typically five years. Under this regulation companies such as Endeavour Energy or United Energy Distribution receive an agreed return for the stated five-year period.

While demand might drop year-to-year they will still receive the agreed revenue as stipulated by the regulator. In current times it's not difficult to see demand remaining relatively flat. Industrial demand might be offset by families use more power while staying at home 24/7.

Another place where we have a high proportion of our credit exposures is our bank senior debt. Our banks have some of the highest capital ratios in the world – and thanks to our regulators since the GFC have very strong balance sheets. Current support by the RBA – with term funding at 0.25% – also mean they are not in a difficult funding situation. This has seen their credit spreads widen only a small amount compared to offshore banks.

For example, 5-year major bank senior unsecured bonds spreads have widened more than 50bps. However in USD, major bank senior unsecured paper has had a trading range of 200bps. Some of this spread has come in recently as liquidity and RBA actions promoted more re-assurance in banks funding and liquidity. Senior bank debt continues to be one of the most liquid segments in the Australian investment grade space, making it very attractive to active investors such as Pendal which seek to increase and decrease credit risk actively.

How to balance out risk and reward

Duration continue to be one of the key areas of diversification within income strategies. While many income strategies focus on floating rate securities to minimise interest rate risk, this is often at the detriment to investors.

In recent months, and over time, the active management of duration has cushioned the impact of credit spreads widening. While lower bond yields do lower this offset relative to previous periods of higher rates, it has not negated them completely. As we are seeing in US markets, and even in New Zealand, the potential for negative rates in all countries should not be ruled out. This makes bonds still attractive to own, but it requires more active management of the duration risk.

The ability to actively manage duration is a core skill set of Pendal's Bond, Income and Defensive Strategies boutique – and continues to be part of most of our income strategies. While the opportunities to invest in higher-yielding corporate bonds is attractive, we are cognisant that the economic outlook is uncertain and the potential for secondary virus impacts is quite high.

A balanced portfolio of high-quality, Australian investment grade bonds combined with active duration can be the solution to manage these uncertain times for investors, providing a solid core of income and downside protection.

For more information contact your
key account manager or visit **pendalgroup.com**

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