Damien Wood, Principal

Spectrum Insights

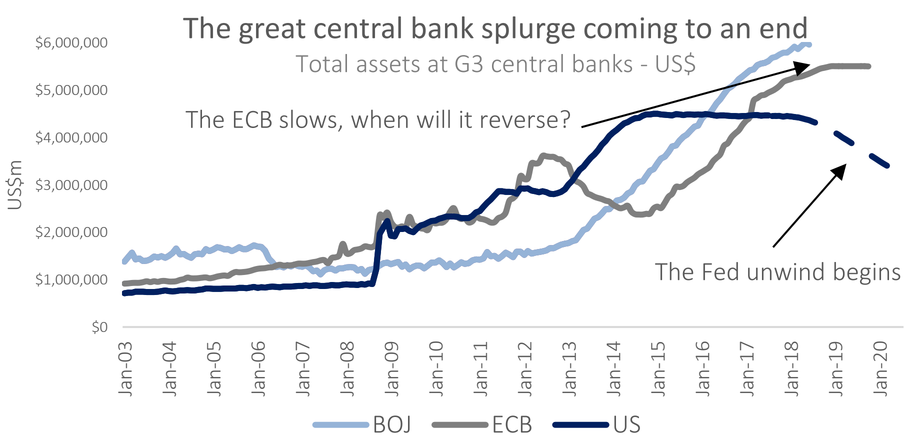
SEPTEMBER 13, 2018

Turning tide to reveal more credit uglies

The saying goes that a rising tide floats all boats. In the land of credit, it has been a king tide enabling almost anyone to get a loan or issue a bond - as long the interest paid was high enough. This works fine when someone else is willing to refinance the weakest as the debt comes due. But when liquidity starts to drain and there is some rationing of credit funding, it can expose some ugly borrowing creatures. This is starting to happen.

Globally, major central banks have provided the great sea of liquidity, known as quantitative easing, since the global financial crisis (GFC) of 2008-9. In Australia, liquidity was long abundant to fund residential property. Now these king tides are starting to turn. The impact so far are sharply wider credit spreads for the likes of Turkey and Argentina in global debt markets and weakening home prices in Australia.

Unless the ebb current slows, the outflow will expose more mal lending of the past. This could become a broader problem for investors including those in A$ corporate bonds. We continue to keep a close eye on the movement in the water line as a guide to how defensive our income focused portfolio becomes.



Sources: FRED, Spectrum, ECB, US Federal

JPY held static as 111 USD, EUR at 1.1643

The importance of big liquidity shifts

Large shifts in the direction in the flows of funds usually drive major investment price movements. A surge in demand will typically push prices up. A surge in selling will push prices down.

Excess liquidity or availability of funding to borrowers sowed the seeds of the GFC. Eventually, an inability to refinance debt and forced selling – the reversal of liquidity – accentuated the fall in asset prices as the crisis unfolded.

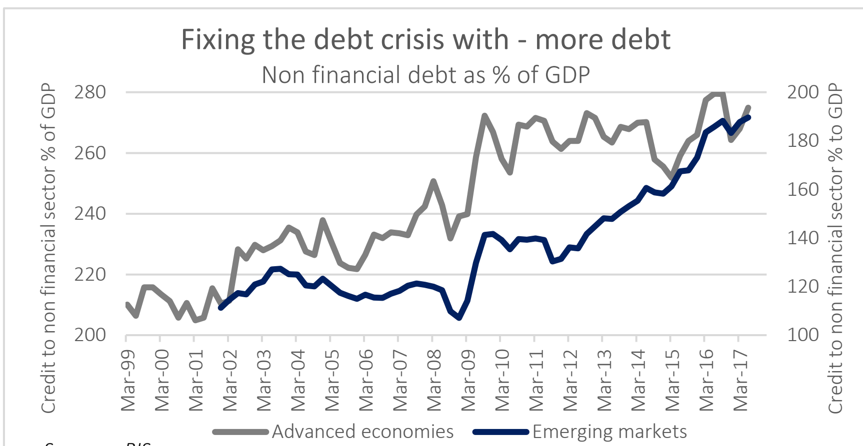
Financial market history highlights that the turning of liquidity direction often points to nearing the bottom or top of investment cycles. Now we are nearing another key turning point in global investment liquidity.

Today's challenges as the tide turns

- #1 Coping with the unwinding of central bank stimulus: Post the GFC, the major central banks around the world accumulated assets worth around $US12 trillion in value or the equivalent of nine times the size of the Australian stock market. This unusual strategy is commonly known as quantitative easing (QE). This surge in official demand contributed to an elevation of asset prices across the globe. Now the U.S Federal Reserve is reversing, albeit gradually, its holdings. The European Central Bank has stopped accumulating assets and we await its unwinding plans. The $US12 trillion question is - if quantitative easing helped push asset prices substantially higher will its reversal have a similar but offsetting impact on asset prices?

  To date, the impact of the early steps of QE reversal is moderate for global markets. U.S government bond yields may be heading back towards "normalized" levels but the damage done to economies and the broader investment universe appears measured so far. What happens when the unwind of quantitative easing starts to accelerate should the ECB join the US Federal reserve in late 2019 or earlier is of greater concern to us.

- #2 Coping with record debt levels: The suppression of global yields from QE created a thirst for yield and yearning to borrow. The central bankers' "rescue plan" to offset the fallout of a debt crisis created an even higher level of indebtedness! Total global debt has climbed from pre-crisis level $US100 trillion to now around $180 trillion[1]. Or expressed another way in the graph below, debt has soared in relation to the size of global economies since the GFC. In emerging markets, debt has almost doubled the proportion to GDP over the past decade.

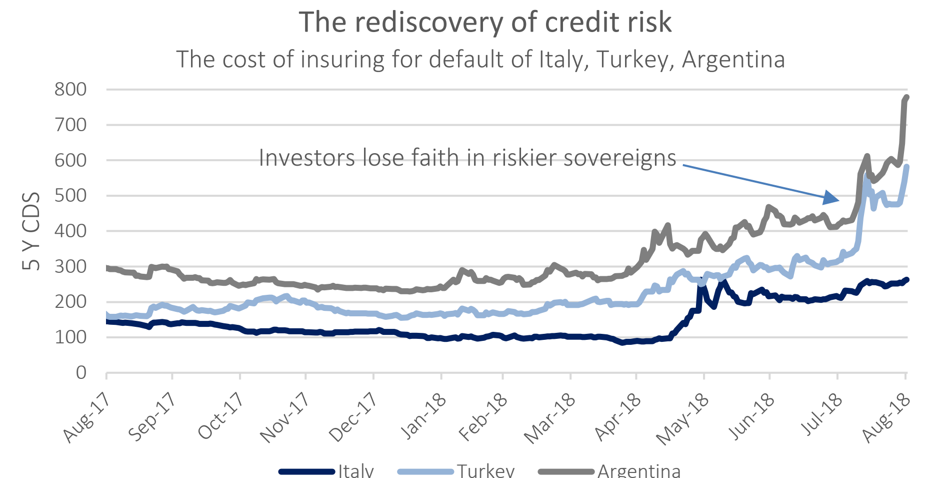


Sources: BIS

  Liquidity was so abundant and yields so low it resulted in a boom time for frontier countries coming to international bond markets. Angola, Ghana, Iraq and Tajikistan issued bonds at yields in the region of 6% to 8%. Argentina – a serial defaulter – was able to issue a 100 year bond.

  But now the quest for yield has started to ebb. For example, the US Federal Reserve hiked official US$ rates from 0.25% in late 2015 to 2% now. The consensus is it will rise to 2.5% in the coming months. The need for investors to boost yields by taking risk from countries they cannot find on a map is falling.

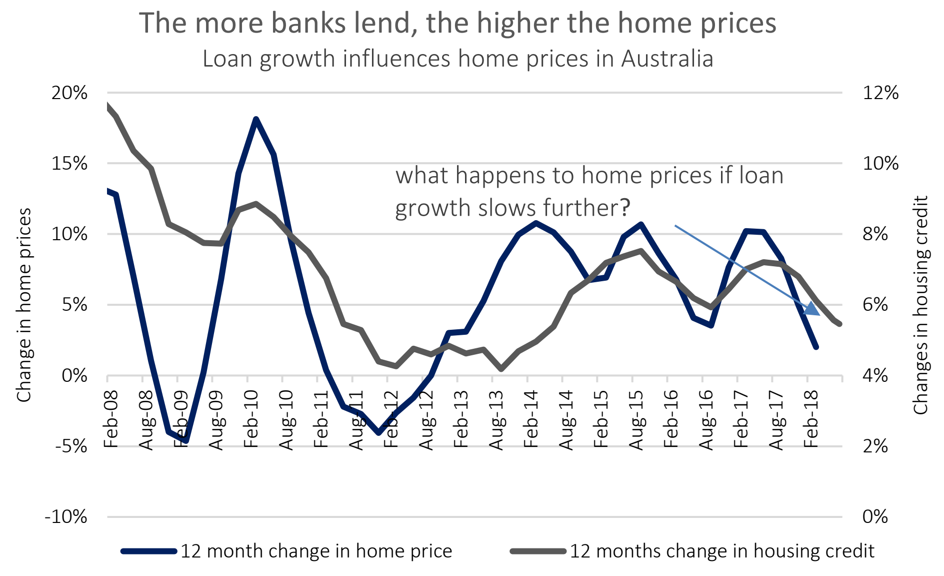
As a consequence, the perceived default risk of two prolific emerging market borrowers – Argentina and Turkey – has recently soared. And perhaps the biggest risk to global markets is the G7 member, Italy, whose investment grade debt rating increasingly appears under pressure.



Sources: Reuters

Emerging market credit is flashing amber. Italy is on watch alert. We monitor other highly indebted sectors, such as US high yield, as global liquidity tightens further.

- <u>#3 coping with stingier lenders in Australia:</u> In Australia, most homes are purchased with credit. Credit was abundant to home buyers for most of the past decade. Now that there is growing evidence of tighter lending standards, we ponder what impact there will be on house prices and, in turn, problems for the largest bond issuers in Australia - banks.



Sources: ABS, RBA

The history of financial crises around the globe shows that lenders are usually willing to lend until the fear of loss reaches a tipping point. Generally, this tipping point coincides with an increase in realized losses. Should lending go into reverse and loan liquidity dry up for the home sector then the risk of credit shocks to the Australian bond market will rise.

At Spectrum, we view investor and interest only borrowers, in general, as the most likely source of lender pain. At present, in Australia home mortgage losses are minimal. Australian mortgage stress is on amber alert but not yet flashing.

So what for our corporate bond market?

Global markets are linked. The performance of our investments is impacted from what happens in debt markets abroad and the performance of our domestic economy. We monitor developments that may point to an acceleration in liquidity withdrawal and seek to shun bonds that will be largely impacted this.

1. From BIS data. Includes credit to non- financial sector from all sectors at market value in US$ from all countries that provide data to the BIS.

dwood@spectruminvest.com.au
(612) 9299 2288