Australian credit – can the outperformance continue?

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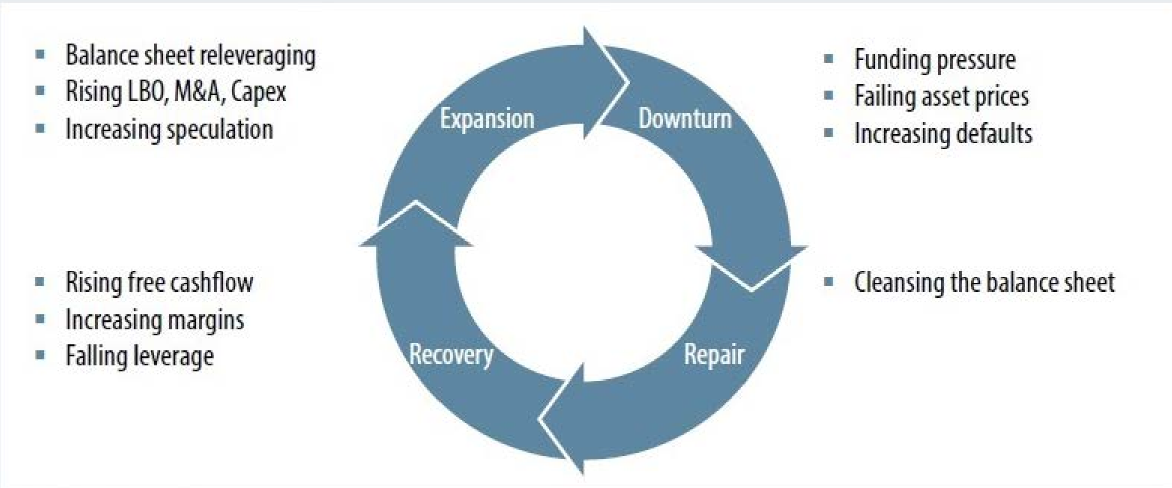
There is no doubt that we have been living through an extraordinary period of economic stability, characterised by low but stable global growth and fueled by central bank largesse, persistently low or even negative interest rates and a seemingly insatiable appetite for risk assets. Given this extended period of economic expansion, and multi-year strong credit performance, the question naturally arises as to where we are in the credit cycle and whether current valuations warrant further outperformance.

The credit cycle – a primer

Credit cycles are generally considered to have four distinct phases: expansion, downturn, repair and recovery (Exhibit 1). All credit cycles ultimately end in a downturn. While this outcome is inevitable, the timing of transition from expansion to downturn is not and the turning points are never easy to predict. Credit cycles do not die of old age. They do, however, tend to follow the direction of the broad economy and are typically presaged by a turn in economic conditions, tightening lending standards and heightened funding costs. As the availability of capital falls, and the cost of servicing debt increases, defaults rise as companies that had over-levered in the good times struggle to meet financial obligations under the weight of excessive debt loads and falling revenues.

Exhibit 1: Phases of a Credit Cycle



Source: Western Asset

The Australian economy continues to defy gravity

Australian economic conditions remain conducive to a continuation of the current credit cycle. GDP growth currently sits at 2.4%, with the Reserve Bank of Australia (RBA) forecasting growth of 3% and 3.25% for 2018 and 2019, respectively. Importantly, growth remains well balanced and supportive for domestic companies. Business conditions remain robust. Unemployment has remained stable and now sits at 5.5% with ample spare capacity, and inflation remains below the RBA's target band of 2-3%.

If there is a downside to this picture, it is clearly the consumer. Household debt-to-income has risen exponentially, wages have stalled (recording a cumulative growth rate of 0.2% in real terms since 2012) and savings rates continue to fall. Key risks remain in the housing market, with the rise in investor and interest-only loans.

The active use of macro-prudential regulations by the Australian Prudential Regulation Authority (APRA) has been successful in reducing the risks of the housing sector overheating albeit risks still remain. The RBA is cognisant that households remain susceptible to any significant upward shifts in monetary policy and has subsequently been reluctant to raise the cash rate above the low of 1.5% set in August 2016. We do not see any obvious driver for this policy setting to change in 2018.

Australian corporates remain in good health

Corporate Australia is coming from a position of relative strength. The latest corporate earnings season has shown a continuation of this trend with improved revenue, stronger earnings and a slightly more optimistic outlook. Corporate credit quality remains sound. Gearing ratios generally remain towards the lower end of target ranges (or below) and debt coverage ratios remain healthy (see Exhibit 2 on page 3 that is based on ASX 100 companies (ex financials), equally weighted). To date, corporate treasurers have tended to be well behaved, with returns to shareholders via dividends and buybacks being largely credit neutral.

A deeper look into the balance sheets of many Australian corporates highlights that corporate treasurers have become more prudent in the management of their debt profile post-GFC. An historical reliance on short term bank funding has given way to more balanced approach to debt funding, with treasurers actively smoothing out and extending their debt profile, and increasing their use of debt capital markets. A deepening domestic bond market now provides companies with the opportunity to raise debt funding out to 10 years (up from five years pre-GFC). Australian corporates are now in a stronger position to deal with potential reductions in capital availability from any one source.

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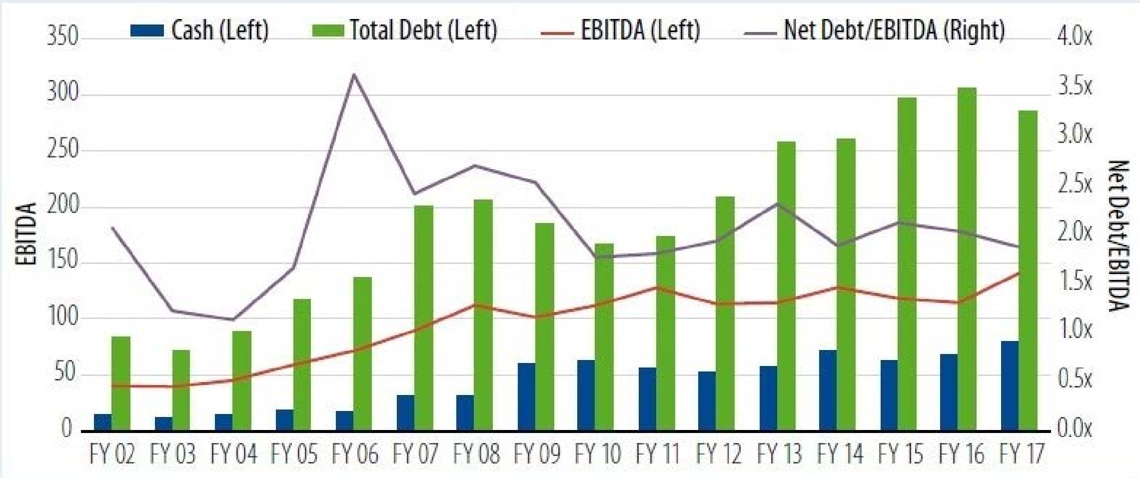
Exhibit 2: Corporate Fundamentals Remain Robust



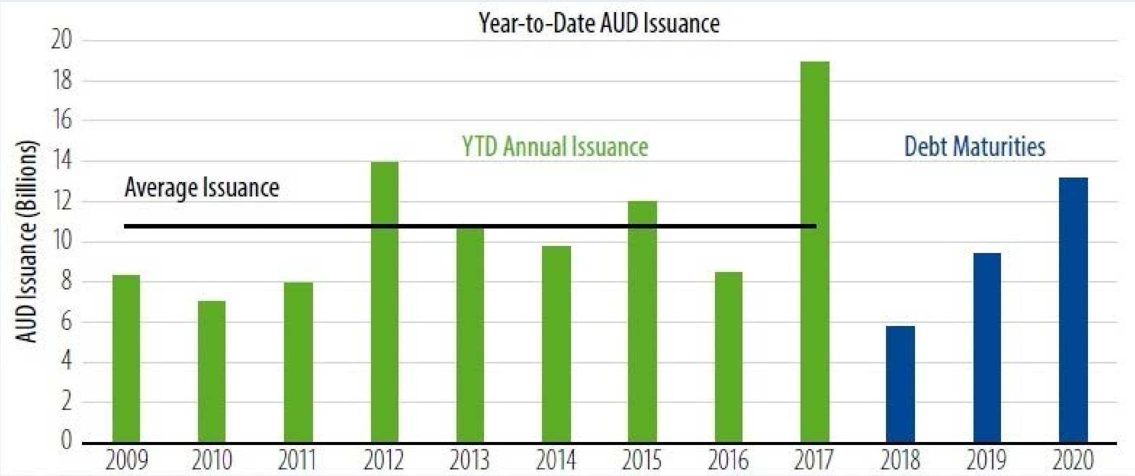
Source: Bloomberg

Technical tailwinds continue to support spread product

Global quantitative easing programs, changing demographics and excessively loose monetary policy have driven an insatiable appetite for risk assets as investors hunt for yield globally—driving spreads tighter and reducing the duration and magnitude of any bouts of volatility. While the process of normalisation has begun, it will be a gradual process and we would expect high levels of demand for income-producing assets to continue.

Additionally, corporate issuance is likely to fall for the remainder of 2018 and into 2019 (Exhibit 3). 2018 is expected to be the lowest maturity year in Australian credit markets since 2013, with only a slight pickup in 2019. Refinancing requirements are only $6 billion this year across corporate issuers, and we would expect some of these to not refinance. Additionally, modest growth in CAPEX requirements and to date, limited debt funded corporate actions, should also act to curb any significant supply of corporate issuance into the domestic market place.

Exhibit 3: Refinancing Requirements Going Forward Are Limited

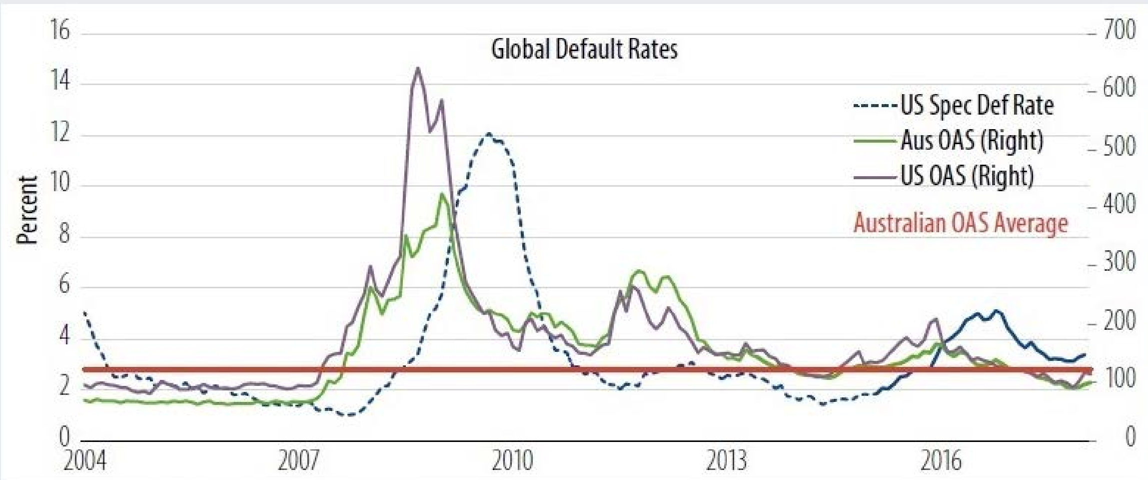


Source: CBA, YieldBroker. As of 31 Dec 17

Australian valuations

Domestic credit spreads tend to display lower volatility than global peers due to Australia being a strong investment-grade market with a much shorter duration than global markets[1]. It remains the case, however, that regardless of the domestic economic outcomes and the relative strength of corporate Australia, the performance of our credit market is largely dictated by movements in offshore, and in particular US, markets. Historically, there has been a strong correlation between US speculative grade default rates and AUD corporate spreads (Exhibit 4).

Exhibit 4: When the US Sneezes the Australian Credit Market Catches a Cold



Source: Bloomberg, S&P Global Ratings. As of 31 Mar 18

[1] AusBond 0+years Credit Index is 3.82 years in duration with an average rating of A+, against the Barcap US Credit Bond Index of 7.04 years duration and an average rating of A as of 30 April 2018.

This relationship is no more evident than during the GFC - why did our spreads widen if there was neither a domestic economic recession, nor a subprime housing sector? The answer is that global funding markets are interrelated. Australian credit markets are truly global in nature. Approximately 50% of the value of the Australian corporate bond market[2] is issued by global companies. Additionally, Australian institutions derive much of their funding from offshore markets, particularly the major banks.

Where to from here?

Absent any exogenous shocks to the system, we do not see any imminent threat to the current credit cycle, either globally or domestically, for the remainder of this year.

We appreciate that Australian spreads have come a long way since the GFC and are now sitting slightly below long-term averages. While we believe that we are being adequately compensated for default risk at these levels, there is limited upside to be gained from taking on too much risk. The cycle is clearly getting on in age and we feel that domestic credit spreads will be largely range-bound for the remainder of this year. Global bouts of volatility will remain a key driver of domestic spreads.

What does that mean for our domestic credit strategy? We continue to stay invested in credit, but for now prefer to focus on those sectors that offer decent carry and stability of cashflows, in particular infrastructure, utilities and property. While the banking sector clearly has its problems, we remain of the view that globally banks remain on sound footing and we are happy to accumulate as valuation opportunities arise.

Investing in shorter-dated credit will act to minimise any volatility that may occur as the market slowly moves towards the turning point in the cycle. In this environment, bottom-up analysis is key. Avoiding companies that have exposure to more cyclical parts of the economy (i.e., exposure to retail in an environment of a stressed consumer) will serve portfolios well. This focus on the fundamentals will also continue to drive our tactical positioning across portfolios as we look for opportunities to invest in primary issuance that offer excess premiums and also take advantage of any short-term technical volatility that may result in mispriced investment opportunities in the secondary market.

[2] As reflected by the AusBond 0+yrs Credit Index