UniSuper

August 2014

Investment Market Update

The Australian share market posted its strongest monthly performance in a year in July, rising 4.4% as evidence mounts that the Chinese economy is starting to stabilise again after the Government's latest easing initiatives. More recently however the market has taken on a weaker tone as an accumulation of negative headlines weighed on sentiment.

This month we take a closer look at the credit cycle. Though we feel the global macroeconomic environment continues to support low corporate defaults, we are becoming more cautious on credit exposures at current tight credit spreads.

Performance of key markets

	% CHANGE				
	MONTH	FYTD	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian Shares (ASX 300)	4.4	4.4	16.3	13.0	10.3
US Shares (S&P 500) in US Dollars	-1.4	-1.4	16.9	16.8	16.8
US Shares (S&P 500) in Australian Dollars	0.1	0.1	12.9	23.5	14.2
Asian Shares (MSCI Asia)	3.6	3.6	13.9	3.1	5.8
Australian Dollar (AUD/USD)	-1.5	-1.5	3.6	-5.4	2.3
Australian Fixed Interest (UBSA Composite)	0.3	0.3	5.5	6.5	6.9
Cash (UBSA Bank Bill)	0.2	0.2	2.7	3.5	3.9
Balanced (MySuper) option*	**1.8**	**1.8**	**12.4**	**11.5**	**9.5**

Returns are for periods to 31 July 2014. Past performance is not an indication of future performance.

* *Returns relate to our Accumulation (not Pension) investment options and are published after fund taxes and investment expenses, other than account-based fees.*

See performance information for all options

The Australian share market posted its strongest monthly performance in a year in July rising 4.4%. Resource stocks in particular benefitted from the mounting evidence that the growth cycle in China is starting to stabilise again after the Government's latest easing initiatives.

More recently, the market has taken on a weaker tone. It appears the build-up of negative news headlines in recent weeks has begun to take its toll. Western governments imposed further sanctions on Russia, violence has escalated in Gaza, the parent company of a Portuguese bank defaulted on its interest payments and Argentina moved into technical default on its bonds. Sentiment has remained poor even though some of these issues appear closer to resolution.

Is the credit cycle ringing alarm bells?

When someone mentions an asset bubble, most would initially think of the stock market or housing prices. But other markets can also experience bubbles, including the credit market. Looking back to 2008, the Global Financial Crisis (GFC) was at its roots caused by an overly exuberant credit market.

The credit market is the universe of debt instruments that are not issued by a government and plays a critical role in providing non-bank funding to the private sector. Though it includes corporate bonds, loans and securitised products, in the context of this market update we focus on corporate bonds.

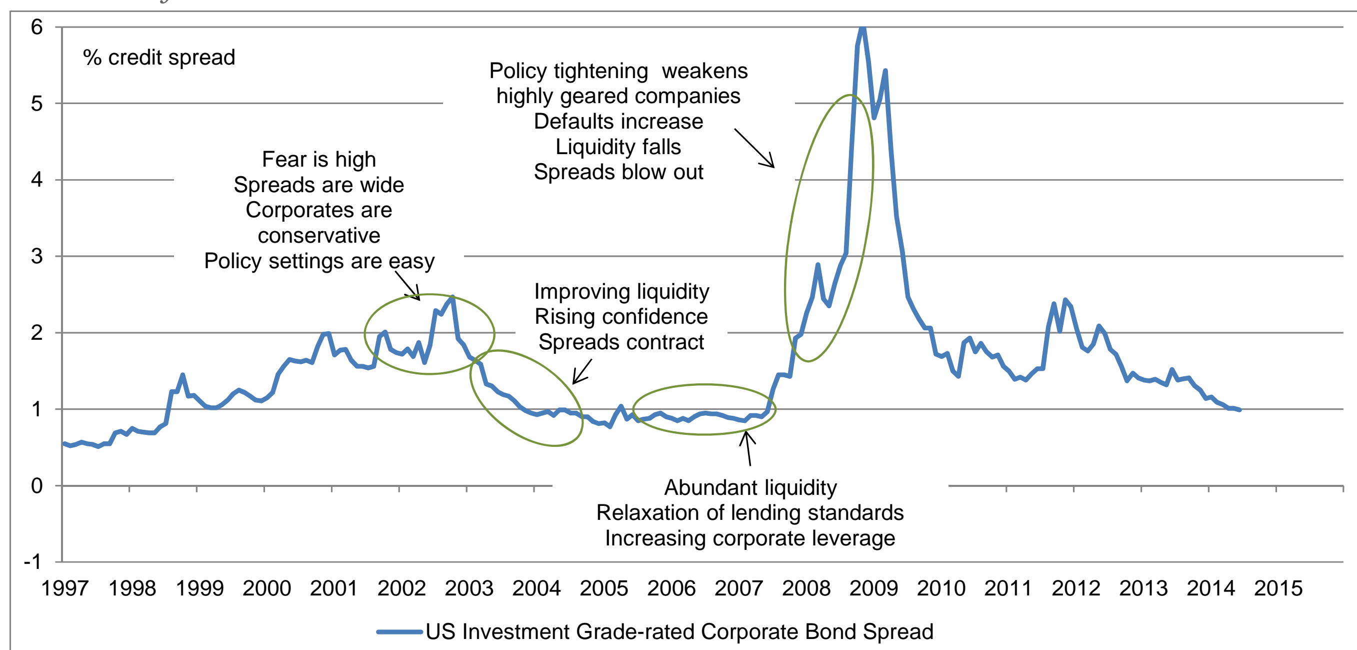
Bubbles or cycles in credit markets are a recurring phenomenon caused by the same investor behavioural factors or 'animal spirits' (or human emotions that drive investor optimism) that influence all financial markets. The consequence of these credit cycles can also be significant.

What is a credit spread?

For those less familiar with credit markets, an important concept to understand is the 'credit spread'. The credit spread is the difference between the return an investor earns by holding a

corporate bond to maturity and that of an equivalent government bond. This spread compensates the investor for a number of additional risks, particularly the risk that the company may default on its payments.

The credit cycle



Source: Bloomberg. UniSuper

If credit spreads are elevated or wide, then an investor is being paid a lot for bearing the default risk on a bond. Provided the risk of default is low, this is often a good time to take on credit exposure. In contrast, if spreads are low or tight, then investors are not receiving as much compensation for the additional risk being borne.

Credit spreads and the credit cycle

The level of credit spreads also provides a useful barometer to gauge the progress of the credit cycle. The credit cycle is the interaction between credit spreads, policy settings, investor risk appetite and corporate behaviour.

The chart above shows the average credit spread across US Investment-Grade (IG) rated companies through time. We have also overlayed the development of the credit cycle that led up to the GFC.

If we take 2002 as a starting point for the cycle, investors were fearful and demanded a high spread to compensate them for taking on credit risk. However, under the influence of stimulatory monetary policy and improving macroeconomic conditions, this gave way to increasing risk appetite. The attractiveness of the high level of spreads fuelled rising investor demand and credit spreads began to tighten. Returns on corporate bonds are highest in this type of environment.

As the liquidity environment became more abundant, investors were willing to accept lower credit spreads. They began to take on more risk to achieve higher return and relaxed lending standards. This allowed companies to increase their own leverage which led to growing market vulnerabilities.

Finally a catalyst (usually tighter policy or falling profitability) exposed these vulnerabilities and companies' ability to service debt fell. As the risk of higher defaults became apparent, investor fear again increased and spreads widened. Returns on corporate bonds are low or even negative in this type of environment.

Where are we in the credit cycle today?

Looking at the current credit market environment, it's clear that spreads have narrowed considerably and are now once again at the tight levels that preceded the GFC. We note however that such an environment can persist for some time before spreads blow out. The key to the longevity of the cycle is whether cheaper credit leads to riskier behaviour by companies.

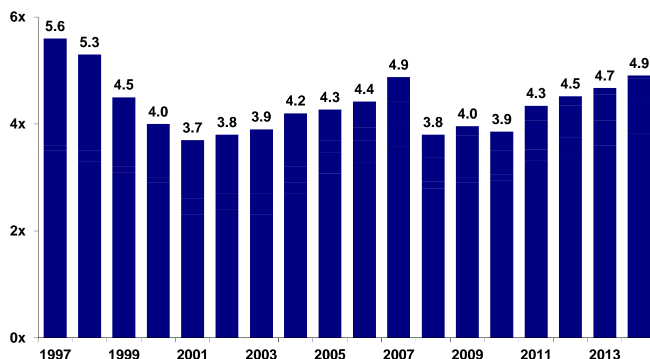
In this regard, we are now observing late cycle characteristics creeping in:

- Though there has been a pullback in recent weeks, appetite for poorer quality sub-investment grade investments is strong and spreads in highly speculative companies offer

very little additional yield compared to lower-risk companies.

- Lenders are now accepting an increasing number of deals with fewer covenants. Covenants are restrictions placed on the borrower that can help minimise losses for investors.
- Payment-in-Kind (PIK) issuance (which is a classic example of aggressiveness in a financial system) is up substantially. PIK bonds and loans offer companies with typically poor cash flows the ability to borrow money without having to pay cash interest until maturity.
- Most importantly, corporate leverage has been increasing. The following chart shows the ratio of debt to operating earnings of the companies in the sub-investment grade US bank loan market. This ratio is once again at its pre-crisis peak.

Sub IG Bank Loan Leverage Multiples (Debt/EBITDA)



Source: Oak Hill Advisors, S&P LCD

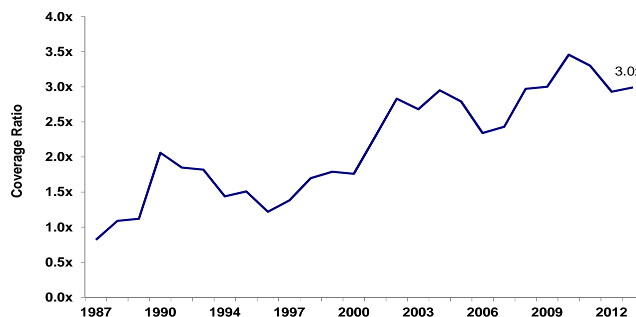
Despite mounting risks, defaults remain low and serviceability strong

Despite evidence of rising risk appetite in the market, we see supportive monetary policy as a major factor that could sustain current market conditions for several quarters. Low global cash rates have reduced interest costs and allowed companies to maintain strong debt serviceability metrics (such as the ratio of operating earnings to interest – see the following chart).

Combined with a low level of debt maturities in the next 12-24 months, we feel the current macroeconomic environment continues to support low default rates and tight credit spreads.

However we are cognisant that indicators suggest we are getting close to the end of the cycle and acknowledge that eventually, higher rates or weaker profitability could see a breakdown in credit quality. While trying to time the turn in credit spreads is difficult, prudence tells us to proceed with caution.

Interest coverage of Sub IG US bank loan issuers remains strong



Source: Oak Hill Advisors, S&P LCD, (EBITDA-CapEx)/Cash Interest.

Introducing the Diversified Credit Income option

On 1 September, UniSuper is planning to launch a new single asset class option – Diversified Credit Income.

Our Pre-Mixed investment options already have exposure to corporate credit as appropriate to their risk characteristics. However, this new option will give members the ability to take on corporate credit exposure if they prefer to build their own diversified portfolios through our suite of single asset class options.

Given where we are in the credit cycle, market conditions may not be ideal to be adding to corporate credit exposure at this particular time.

However it is very difficult to determine the perfect timing to launch a new option. We are introducing this new option now to fit in with UniSuper's product and business planning cycle and more importantly so that a product is available if and when the time is right.

Members can expect a low-key introduction to the option at launch, but can be assured of its availability once the credit cycle turns and a more favourable entry point presents itself.

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