

The Credit Clock: revisiting sovereign debt

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INSIGHTS

Key points

- Ongoing global debt issues in both sovereign and corporate markets have prompted a return to the credit clock, 6 months on from our first analysis.
- Having reviewed and analysed our data sets, in our view the recovery in Australia will remain slower than expected.
- Australian credit remains attractive on a yield basis, in terms of the relative strength of the Australian economy, and on the strength of Australian balance sheets (which to date have not been dependent on M&A activity for funding).

Revisiting the credit clock

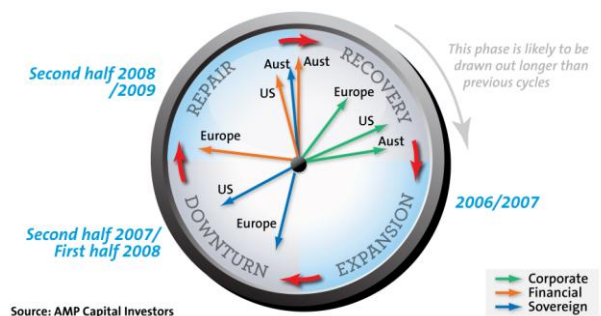
In January 2011, we issued our first research piece covering the theoretical credit clock¹, and, in particular, how the usual business or credit cycle may have been affected by the extreme events of the financial crisis in 2007-2008.

We found that there were three main factors that will make this economic recovery and ensuing investment environment different to previous recoveries: change in global banking regulations with Basel III; exposure to the risk of sovereign defaults; and a stuttering mergers and acquisitions market.

As a result, we surmised that this would lead credit assets to outperform similar equities for a more prolonged period than normal on a risk adjusted basis.

As part of our ongoing macro credit strategy, we have updated our analysis based on our data sets which include the most recent corporate earnings season and government budget forecasts.

The credit clock: Australia, Europe and the United States as we saw it in January 2011



We believe that though the recovery will be drawn out longer, steady re-leveraging through shareholder activity and increasing M&A activity will be much more muted and unlikely to impinge on the underlying strength of corporate balance sheets, leading to retaining attractive credit spread valuations and ultimately, we believe, corporate bond outperformance.

Supporting better credit market conditions going forward is the international adoption of new Basel III regulations. These regulations are expected to impact investors in a range of positive ways, including:

- driving further deleveraging to ensure that banks will no longer be 'too big to fail';
- increasing balance sheet liquidity;
- improving capital adequacy; and
- improving transparency.

Sovereign risk and more on gross US debt

America's public debt situation remains a major challenge for investment markets going forward. On a gross public debt basis, the US is currently in worse shape than Spain

¹ This research is available on our website: ampcapital.com.au

and Portugal, and long-term projections suggest it is on an unsustainable path considering the scale of the problem.²

The budget deficit in the US (covering all levels of government) is around 10.8% of gross domestic product (GDP) this year, well above that for comparable countries such as the UK (8.6%), Europe (4.4%) and Australia (2.5%) – as illustrated in the table below.

US compared - budget deficit and debt projections

	% GDP		Budget balance		Gross public debt	
	2010	2011	2012	2016	2011	2016
US	-10.6	-10.8	-7.5	-6.0	99.5	111.9
France	-7.0	-5.8	-4.9	-1.5	85.0	84.1
Germany	-3.3	-2.3	-1.5	0.0	80.1	71.9
Greece	-10.5	-7.4	-6.2	-2.1	152.3	145.5
Ireland	-32.4	-10.8	-8.9	-3.8	114.1	121.5
Italy	-4.6	-4.3	-3.5	-2.9	120.3	118.0
Portugal	-9.1	-5.6	-5.5	-5.9	90.6	106.5
Spain	-9.2	-6.2	-5.6	-5.0	63.9	75.9
Euro-zone	-6.0	-4.4	-3.6	-1.8	90.4	89.0
UK	-10.4	-8.6	-6.9	-1.3	83.0	81.3
Canada	-5.5	-4.6	-2.8	0.0	84.2	72.6
Japan	-9.5	-10.0	-8.4	-7.4	229.1	250.5
Australia	-4.6	-2.5	-0.6	0.7	24.1	20.6
OECD	-7.7	-7.1	-5.2	-3.5	101.6	107.3
Emerging countries	-3.8	-2.6	-2.2	-1.2	35.3	30.2

Source: IMF projections, AMP Capital Investors

Following the stimulus package of late last year, the US will be the only advanced country other than Japan to see its budget deficit worsen this year. It is expected that 2012 will see significant fiscal austerity as global financial crisis stimulus measures expire – amounting to a fiscal cutback of around 2.5% of GDP.

While not as bad as Greece and Ireland, the level of net public debt and interest expense in the US is more comparable to a AA-rated country (such as Belgium, Spain, Israel or Japan), rather than to a AAA-rated country (such as Germany or Australia).

Based on current policies, America's budget deficit is expected to remain well above comparable countries in five years time, and its level of gross public debt to GDP will have risen above the Organisation for Economic Cooperation and Development (OECD) average.

Projections by the US Congressional Budget Office - based on the assumption the Bush-era tax cuts are extended and allowing for ballooning age-related spending - are expected to see federal gross public debt rise from 62% of GDP in 2010 to 200% of GDP by 2040. This is clearly not sustainable in the long-term.

The IMF projects that for the US to reduce its gross public debt to pre-crisis levels of around 60% of GDP by 2030, tax hikes or spending cuts of around 11% of GDP would be required. Factoring in increased spending on social security

and health pushes this out to around 17.5% of GDP. This is well above that required for other OECD countries.

While some US states (notably California and Illinois) and local governments have excessive debt, the bulk of the deficit and debt is at the federal level. State and local government budget deficits will account for just 1.1% of GDP this year and their gross public debt was around 30% of GDP in 2010, compared to about 62% of GDP at a federal level.

Roughly 47% of US federal debt is held by foreigners, up from 36% eight years ago, with half of this held in China, Hong Kong and Japan. This contrasts with Japan where less than 5% of debt is held by foreigners. America's status as a net debtor country with a huge budget deficit and a current account deficit imparts a vulnerability not faced by net creditor countries such as Germany and Japan. Japan has been able to sustain its high public debt as it largely borrows from itself.

While these statistics paint the US as potentially another peripheral Euro-zone-type sovereign risk, there are a number of reasons that it may not be as bad as it looks.

Firstly, the US borrows in US dollars and doesn't face the risk of a falling US\$ causing a foreign exchange crisis, unlike other countries that borrow in foreign currencies. Secondly, there is a natural demand for US Treasury bonds from investors (to manage their portfolios) and, more importantly, from foreign central banks in the emerging world who are selling their own currencies and buying US dollars as part of an ongoing effort to stop their currencies rising.

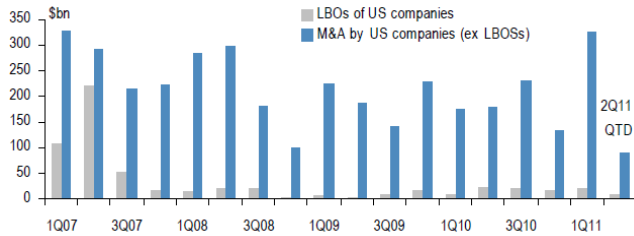
However, the obvious risk is that if the US doesn't move fast enough to set its fiscal position on a sustainable course the patience and support of foreign investors could deteriorate. Pressure for change could also come if central banks in emerging countries stop intervening in their currencies or as the world gradually shifts towards using other currencies than the US\$ as a standard for trade and finance. It will also come as US economic growth recovers, resulting in more competition for funds pushing up bond yields – this is a more immediate risk given that there are signs credit demand in the US is on the rise. The longer-term but present risk is that ratings agencies begin to consider a ratings downgrade for US issued debt.

Corporate merger and acquisition activity

In the US, corporate balance sheets are largely 'repaired' following the shock of the financial crisis in 2008/09. There is now some evidence that companies are starting to focus on growth strategies. This has seen a recent increase in M&A activity by US companies which signals an increase in confidence for future prospects and growth, and a general sense of comfort with the current economic environment.

² This section sourced from Shane Oliver paper, 'US public debt – how big a threat?', AMP Capital Investors, 2011.

Pick-up in M&A activity year-to-date increases the upside risk to investment grade credit supply



Source: Dealogic, JPMorgan

To date, Australian M&A activity has remained muted with only the resource sector showing a notable increase in M&A and shareholder friendly activity as well as other growth initiatives such as a solid forward looking CAPEX program.

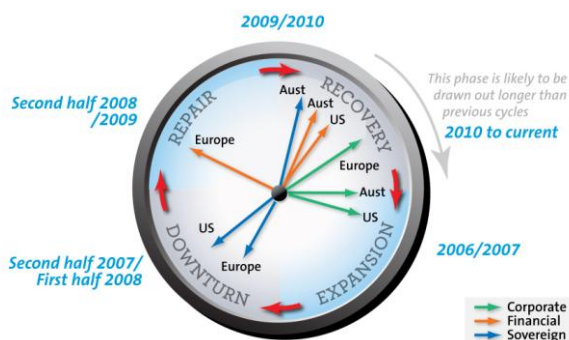
More importantly, balance sheets in general (for non-financials) across US, Europe and Australia are in a particularly strong starting point, and can absorb a reasonable move into the expansionary phase of the cycle before there is a material impact on broad credit metrics.

Corporate leverage is likely to continue to move higher as accelerating earnings emboldens management to pursue increasingly large M&A transactions while also increasing payouts to shareholders (dividends and buyback). While on the surface, this is clearly a less credit friendly environment than the past two years, to the extent economic growth remains positive and corporate earnings accelerate, we believe spreads for non-financials are unlikely to widen materially.

Revisiting the credit clock

Given developments in Europe and the US on sovereign debt, and a still muted mergers and acquisitions environment, the credit clock has changed since we analysed it in January 2011.

The credit clock revisited June 2011



Source: AMP Capital Investors

We believe corporate Australia is on the borderline of the 'Recovery' and 'Expansion' phase and is perhaps likely to remain at this stage of the cycle for a more prolonged period than 'normal'. With investment grade spreads still above long-term mean levels, there is still an opportunity for investment in this sector, particularly where it is possible to lock into the longer term issues witnessed over the past 24 months.

While the US corporate sector has moved into the 'Expansionary' phase, balance sheets are in good shape and can withstand a substantial amount of M&A and

shareholder friendly activities before evidence of credit metric deterioration and subsequent credit rating downgrades. This is an encouraging sign.

European financials and sovereign exposures look to have a great deal of 'Repair' (and deleveraging) ahead of them before they enter the 'Recovery' phase. Austerity measures resulting from European fiscal deficits will impact on regional economic growth outcomes, which could also have a secondary impact on corporates within those countries.

The European Central Bank has already started to increase rates to target inflation, while the Federal Reserve is waiting to see positive growth come through before moving. The Reserve Bank of Australia is towards the end of their tightening cycle, with one or two more hikes to target inflation expected by the market in the short-term.

Debt plots and the credit clock

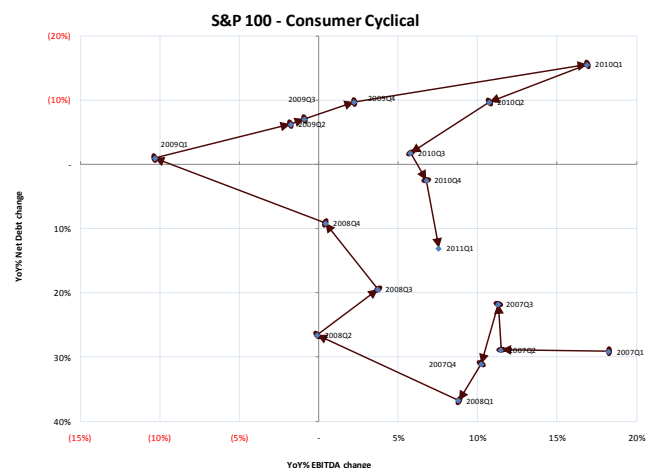
By plotting net debt as a percentage of GDP against a country's ability to service debt, using budget surplus as a proxy, it is possible to generate time charts that illustrate an economy's debt path. The same can be done for companies using net change in debt versus net change in earnings.

The data plots for the debt paths – both for corporates and governments – typically depict the progress of debt over time across four plot-quadrants.

In the case of companies, the bottom left quadrant where net debt is increasing and EBITDA is negative and falling represents the 'downturn' quadrant. The top left quadrant represents the 'repair' phases, where EBITDA begins to improve but is still negative, and debt is still negative or increasing. The top right quadrant represents the 'recovery' phase where debt is decreasing and EBITDA is now positive and improving. Finally, the bottom right quadrant represents return to the 'expansion' phase where EBITDA is positive, and companies look to expand by increasing their debt again.

In the case of sovereign debt plots, the quadrants are similar, however the change in debt is measured against change in net debt as a percentage of GDP, and GDP growth is used as a proxy for a country's ability to pay down some of their debt, as opposed to EBITDA for corporates.

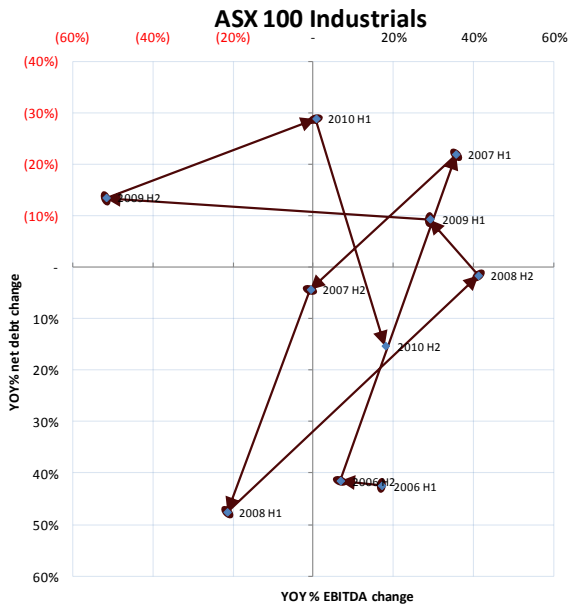
The plot below for US consumer cyclicals illustrates a textbook case of the credit clock in action. We can see two quarters of data showing the more cyclical sectors of the US economy now moving into the expansionary phase (bottom right quadrant).



Source: AMP Capital Investors

The plot for Australian industrials is more benign. Broker consensus forecasts over the next couple of years highlight a fairly prudent view of the next phase of the credit cycle for this sector.

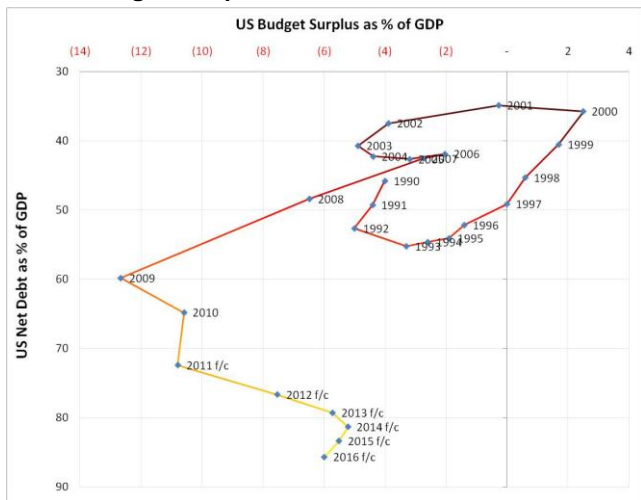
Whilst M&A activity in Australia has broadly increased, this has been concentrated in specific sectors, which distorts the view on what is broadly occurring. Other increases in M&A and shareholder friendly activities overall have not been material enough to impact on credit metrics.



Source: AMP Capital Investor

In the sovereign sector, governments are being fiscally prudent. Austerity measures can impact on regional economic growth outcomes, which could have a secondary impact on corporates within those regions. This is more focused around the Euro-zone, rather than in the US or Australia.

US sovereign debt plot – actuals to December 2010



Source: AMP Capital Investors

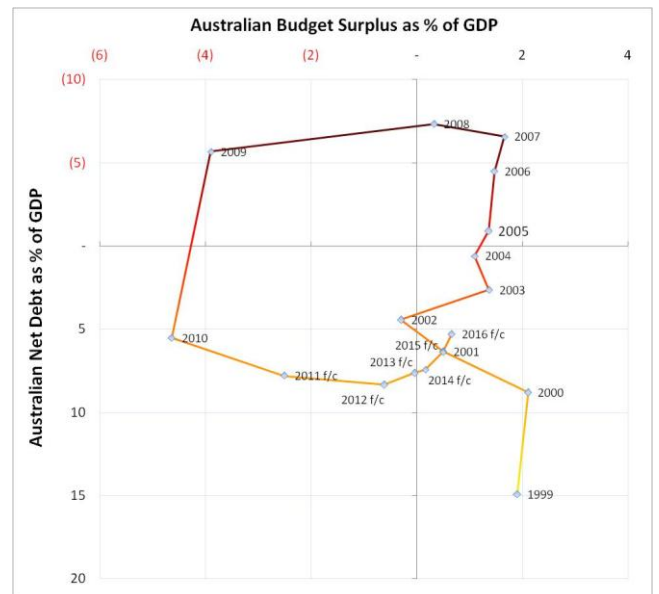
Overall, we are still seeing deleveraging occurring within the banks. Globally, earnings are coming off and we are seeing banks remaining in the recovery phase. This is largely due to refinement in regulations that is occurring across the

world, facilitating increased transparency, and lower leverage that should ultimately result in more earnings stability in the long term.

But there are implications for lending by the banks to corporates. Larger corporates will be forced to tap credit markets to fund themselves, in addition to traditional bank funding. It is expected that this will have an impact through increasing disintermediation in the banking sector, which will ultimately create more opportunities for credit investors.

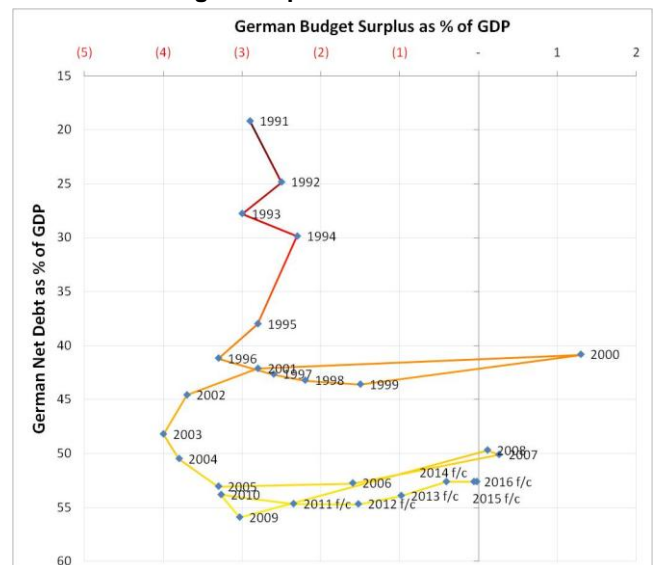
However, there is significant downside to this in the funding markets for small to medium enterprises, too small to be able to tap into investment grade credit markets. This is already being observed in China, where there has been significant disintermediation amongst the banks in terms of funding corporates, due to the sharp increases in reserve requirement ratios (RRR) Chinese banks are required to hold against their asset books.

Australian sovereign debt plot – actuals to December 2010



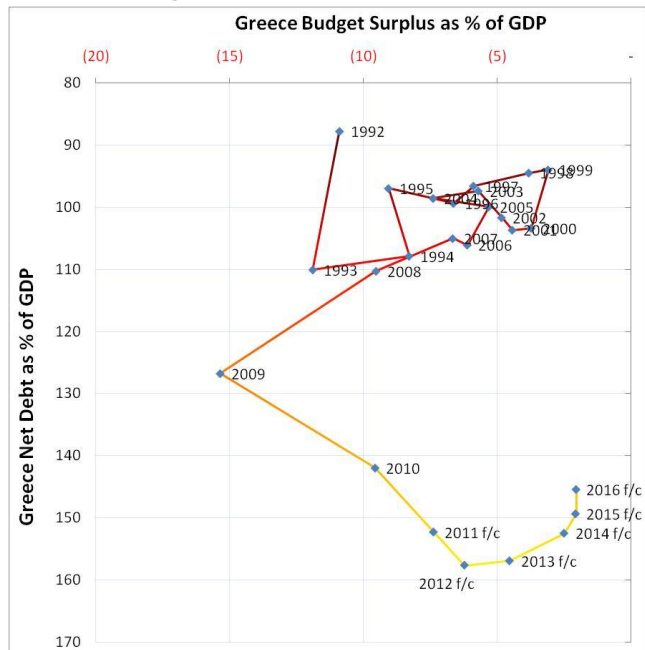
Source: AMP Capital Investors

German sovereign debt plot – actuals to December 2010



Source: AMP Capital Investors

Greek sovereign debt plot – actuals to December 2010



Source: AMP Capital Investors

Conclusion of our analysis

Based on our analysis, we expect that for Australia the recovery will be drawn out for a longer period than expected. Steady re-leveraging through shareholder activity and increasing M&A activity is muted, and looks to remain that way in the short term. As a result, M&A activity is not expected to impinge on the underlying strength of corporate balance sheets, which should result in attractive credit spread valuations. For this reason, we believe investing in Australian investment grade credit during this part of the cycle remains compelling for investors.

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