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## Corporate bonds – still in the sweet spot

# INSIGHTS



2009 saw a recovery in returns for many assets. The worst of the global financial crisis may well be over but with rising interest rates and the withdrawal of government stimulus measures, uncertainty still prevails. In this environment, corporate bonds, particularly investment-grade, continue to offer investors an opportunity for relatively high yields and attractive risk-adjusted returns.

### Uncertainty prevails

Last year saw a rebound in equity markets, a further contraction of credit spreads, and a spike in consumer spending from the lows of 2008. While the worst of the credit crisis may be over, there are still questions around the sustainability of world growth in the short to medium term.

Moving into 2010, we anticipate a number of influences that are likely to prevent a shift to more normal economic conditions. As interest rate rises start taking effect, we believe the more developed countries will continue to experience steady but sluggish levels of economic growth. And following the withdrawal of government-led fiscal stimulus initiatives, one of the biggest issues is the ability of major industrialised countries, particularly across Europe and in the US, to transition to sustainable levels of economic growth.

### Credit spreads still wide

Bond markets are also adjusting to this slow growth environment. While credit spreads have contracted from their highs during the global financial crisis, they remain wide based on historical levels. Caution is still required, particularly in high yield or sub-investment grade bonds where some companies face significant refinancing risk and are vulnerable to default. However, we believe investment-grade corporate bonds continue to be attractive.

Australia has undoubtedly survived the global financial crisis and compared to its global counterparts, managed to avoid a recession. Against this backdrop, investment grade corporates have paid down debt and are now generating solid profits. From a corporate bond perspective, this underpins higher security of income together with a reduced probability of default.

### More focussed bond issuance

Across the board, 2009 was a record year for growth in the corporate bond market. This year we believe bond issuance will increasingly provide an alternative funding source for corporates. In a bid to manage greater liquidity including asset and liability requirements post the global financial crisis, banks are looking to issue a comprehensive range of non-government guaranteed debt into the market from shorter term maturities such as three years, all the way to ten year maturities.

Other sectors that continue to present opportunities include prime retail shopping centres, A-grade office buildings and Australian prime residential mortgages. None, though, represent as attractive an opportunity as corporates in the utilities and infrastructure sector that are expected to look to capital market funding solutions in 2010.

### Infrastructure and utilities – a case study

#### A defensive asset sector

The majority of infrastructure and utilities have, as a basic attribute, strong and stable underlying cashflows. Regardless of how the economy is doing, there is ongoing demand for their assets and services such as roads and electricity to meet day-to-day living needs. So the demand for infrastructure and utilities is relatively inelastic to the economic cycle, meaning they are typically conservative predictable businesses.

These characteristics have been evident over the past few years. Many infrastructure and utilities businesses have negotiated the recent economic downturn and global financial crisis relatively well, mainly due to less volatility in their cashflow streams. This makes their debt securities a compelling proposition for corporate bond investors as they have the potential to provide high income stability

#### Expected increase in bond market issuance

The global financial crisis has led many companies, including banks, to focus on deleveraging, making it increasingly difficult for infrastructure and utilities companies to source term funding.

Conscious of a heavy reliance on wholesale funding and a desire to increase funding from retail markets, banks have become more selective about who they will lend to. Consequently for some sectors, bank lending rates have risen dramatically, particularly where the bank has a narrow relationship with the borrowers. Facing significant refinancing, infrastructure and utilities will be forced to diversify funding sources, with capital markets issuance expected to increase in 2010.

To suit the longer term nature of their underlying businesses, infrastructure and utilities companies usually require long term financing solutions. Taking on too much short term debt can represent higher refinancing risk for some issuers. Furthermore the deteriorating credit quality of mono-line insurers such as MBIA and AMBAC that have traditionally provided term funding to infrastructure and utilities companies, have left these businesses with little choice but to explore other forms of borrowing.

Raising debt via the capital markets is one of the more obvious solutions to help these companies grow and develop, and better match long-dated assets with long-dated liabilities.

At the same time, corporates recognise that capital markets are still to some extent dysfunctional, with a low level of investor confidence. So not only will bonds need to be issued at competitive interest rates to attract investors but the quality of debt has to be high. This creates great opportunities for corporate bond investors who have the possibility of locking in investment-grade long term debt at attractive rates of income.

### Greater lending and underwriting opportunities

Opportunities also exist on the debt arranging side. With lessening competition in the provision of debt, we are seeing a shift in the types of organisations that originate debt deals.

For example, because of AMP Capital's size and reputation in the Australian market and the scale of funds under management in investment products like the AMP Capital Corporate Bond Fund, we are one of the few non-bank investment institutions actively involved in the debt origination market. This involves teaming up with other banks and acting in an underwriting capacity to encourage debt raisings to proceed. In return, AMP Capital receives an underwriting fee which is passed directly to our investors. We also have the advantage in negotiating the terms of financing, with a strong focus on covenants to protect the downside for our investors.

## Why invest in corporate bonds

An investment environment where economic growth is neither too fast nor too slow presents a 'sweet spot' for corporate bond investing, particularly in investment grade bonds. Investing in these securities via a managed fund such as the AMP Capital Corporate Bond Fund can give investors access to a diverse portfolio of investment grade, senior bonds issued by good quality companies that make up a significant part of corporate Australia.

We believe the corporate bond sector forms a defensive allocation within a diversified portfolio and has the potential to provide attractive rates of regular income without the need to lock away investors' funds for months or even years. This makes the asset allocation process simpler as funds can be easily moved to other asset classes if and when appropriate.

Specifically, by investing in the AMP Capital Corporate Bond Fund, investors may not only receive this liquidity advantage but also the benefit of regular monthly income spread over the year rather than a single annual payment.

## Contact us

If you would like to know more about how AMP Capital can help you, please visit [ampcapital.com.au](http://ampcapital.com.au), or contact one of the following:

**Financial Planners**

**AMP Capital's Investment Representative on 1300 139 267**

**Private Clients**

**Private Client Services on 1800 188 013**

**Wholesale Investors**

**AMP Capital's Client Service Team on 1800 658 404**

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