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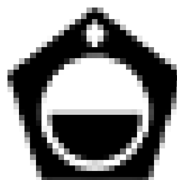
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THE AUSTRALIAN

Energy market fears feed into bonds, equities

STIRLING LARKIN THE AUSTRALIAN FEBRUARY 6, 2016 12:00AM

It has become clear over this summer that markets desire clarity and some degree of certainty surrounding the future of the global economy.

Traditionally, when it becomes apparent that events are more significant than a shorter-term correction, the key conversation among professionals in Australia's ultra-high-net-worth wealth advisory sector quickly shifts to fixed-income investing, seen by most as the prudent and defensive place to turn.

This time around, though, the global investor appears to be caught on the horns of a dilemma because both Australian and international fixed-income favourites, such as government or corporate bonds, are both expensive and unduly volatile. And there is little point turning to a volatile asset class that presents risks equivalent to those found in equities (which also undeniably offer lower longer-term returns).

Since August 2015's so-called "Rates Riot", when markets revolted against the idea of a US interest rate "lift-off" and also when Chinese equity markets peaked and then fell, Australian Government Bonds have led a global fixed-income rally that has left benchmark yields at dangerous levels. This, in part, reflects the three well justified concerns of global investors at this time:

● Attention on Chinese, US, eurozone and Australian interest rate disparities

● Global energy price patterns

● Questions surrounding the depth of liquidity in the most important fixed income benchmark, the US 10-year Treasury Bill market.

Diverging interest rate policies are not unprecedented but the combination of all three is. What's more, with so much continued uncertainty UHNW global investors have been reappraising core, investment grade and also high yielding bond investments.

Even though the US 10-year Treasury Bill market is the deepest of all international markets across any asset class, news reports of Chinese, Saudi and Russian Sovereign Wealth Funds selling large parcels of US 10-year Treasury holdings to support currencies pegged to either the US dollar or energy prices have raised eyebrows even in quarters such as the International Monetary Fund.

When it comes to global energy, Ibe Kachikwu, Nigeria's Petroleum Resources Minister last month at Davos astutely reminded us that, "Everyone emphasises price but (oil) price is really not the issue, it is the future of the oil industry that is the issue … It is a whole lot more than price".

And he was right.

As bond markets in effect reflect the industry's broad composition, what these statements mean for fixed income and specifically bond investors focusing on energy markets is determining which players will ultimately win and what are their probabilities of succeeding. The historically high levels of volatility are also reflecting a concern about this predicament, as after all, it is typically the role of equity not bond markets to separate the wheat from the chaff.

Also remembering that fixed-income investments are traditionally seen as a shelter during volatile times, it has become unsettling to many to now accept that this asset class, in particular, is the actual eye of the global storm.

As the graph highlights, the changes to energy markets seen since the "Oil Wars" began in late 2014 have immediately and directly affected US (and other) high yielding fixed-income markets.

But they have also by extension, transmitted to interbank credit markets, which now has the result of shifting the corporate creditworthiness of large Australian mining and energy businesses, such as BHP and Origin.

Despite these concerns, Deutsche Bank (Australia) this week extended their buy recommendation on both Origin and BHP Hybrids based on these companies' underlying credit fundamentals and valuation.

What the "credit crunch" of 2008 taught Australian local investors is that it is always important to keep a close eye on volatile credit markets and ensure that those levels of volatility do not infect the equity portion of related businesses, in this instance a company such as BHP.

Larkin Group is an ultra high net wealth adviser focusing on high- yielding global investments. www.larkingroup.com.au