AUSTRALIAN FIXED INCOME MONTHLY

August 2020

Australian market commentary

The Australian bond market (as measured by the Bloomberg AusBond Composite 0+ Yr Index) returned -0.42% over the month. The yield curve steepened as 3-year government bond yields ended the month 1 basis point (bp) lower at 0.26% while 10-year government bond yields rose 16 bps to 0.98%. Short-term bank bill rates were largely steady. The 1-month rate was unchanged at 0.09%, the 3-month rate fell 1 bp to 0.09% while the 6-month rate was 3 bps lower at 0.15%. The Australian dollar was stronger, closing the month at USD 0.74.

The Reserve Bank of Australia (RBA) reaffirmed its commitment to support the financial system through a historically low cash rate of 0.25% and yield curve control to keep 3 year bonds at 0.25%. The RBA purchased an additional AUD 10 billion in Australian government bonds during August, bringing the total to AUD 61 billion since March. The RBA also announced it is extending the Term Funding Facility in both size and duration. These measures are intended to keep funding costs low and sustain credit availability.

Domestic economic data releases were mixed in August. Employment rose by 114,700 positions in July, exceeding market expectations. The unemployment rate rose to 7.5%, which was also better than feared, however this was the highest jobless rate since November 1998. The NAB Survey of Business Conditions continued to rebound in July, turning positive at +3 points, with business confidence remains weak at -14. Retail sales were up 2.7%. National CoreLogic dwelling prices continued to fall in August, ending the month down 0.4%.

Australian market outlook

The outlook for both the Australian and global economies continues to be clouded by the COVID-19 crisis. In Australia, the RBA is forecasting a fall in GDP in the year to December 2020 of approximately 6%, with GDP growth of around 5% in 2021. Unemployment is expected to reach 10% by year end, and gradually decline to 7% in the next two years. Inflation is expected to remain subdued, in the 1-1.5% range in 2021-2022.

The Australian government introduced unprecedented stimulus measures to overcome the crisis, and questions still remain over what will happen when these initiatives end. While a number of measures, e.g. JobKeeper and JobSeeker, have been extended to March 2021, these will be at reduced rates. Many countries across the globe will be running deficits of over 10% of GDP. The Australian government is no different and will need to fund large levels of debt issuance this year.

The RBA's quantitative easing (QE) has been designed to make financing conditions easier and to give banks an incentive to make sure the money gets to where it is needed most. While the RBA extended the Term Funding Facility (TFF) and re-activated its bond purchasing in August, we believe the RBA could be doing more to support the market, particularly when you compare its actions to those of other major central banks.

According to APRA, loan deferrals totalled AUD 274 billion, or approximately 10% of total loans outstanding (as at 30 June 2020). The majority of the deferrals (over 70%) are housing loans. APRA has also extended its temporary capital treatment for lenders out to March 2021. However, the regulator expects lenders to encourage borrowers that can restart repayments to do so, and to identify, monitor and manage any loans where this is not possible.

Credit commentary

Credit markets continued their strong run from the last three months and have now recovered to pre-pandemic levels, although a few of the most challenged sectors remain at elevated spreads. Unlike at the start of the rally where most of the performance was in major bank paper, the tightening in August was more evident in the triple-B corporate sector. Domestically physical spreads to government tightened about 9 bps. Both domestically and offshore, synthetic markets credit spreads narrowed: the US CDX s by 4 bps, the European iTraxx by 6 bps and the Australian iTraxx by 11 bps.

After a flurry of rating actions at the start of the pandemic, rating agency actions have been recently quite subdued. At the sovereign level, the US had the outlook on its triple-A rating revised to negative from stable by Fitch. The State of Victoria had its AAA rating placed on CreditWatch Negative by Standard & Poor's (S&P). Fitch revised the outlook of numerous Japanese banks and financial institutions from stable to negative following the revision of the Japan sovereign rating outlook to negative in late July. Affected entities included Mizuho Financial Group, Mitsubishi UFJ Financial Group, Sumitomo Mitsui Trust Bank Ltd, Daiwa Securities Group and Nomura Holdings.

For domestic ratings, despite the difficulties in the aviation industry, Brisbane Airport had its BBB rating affirmed by S&P with the negative outlook retained. Tabcorp Holdings had its outlook revised to stable from negative by S&P. The company's BBB- ratings were affirmed. Australian Gas Networks was upgraded to A3 from Baa1 by Moody's.

The Commonwealth Bank of Australia had an upbeat results report for its 2020 year end while the other three major banks provided quarterly updates which indicated that they were weathering the pandemic reasonably well. The banks were seeing a reduction in the number COVID-19-related payment deferrals but the results were for the period up to 30 June and did not capture the impact of the lockdowns in Victoria. For debt investors however, the main point emerging from the updates is that the cheap debt from the RBA's TFF and slower asset growth mean that Approved Deposit Institutions are unlikely to need senior debt or securitisation in the next year or so. As a result, supply of bank paper will be limited and Tier 1 or Tier 2 debt are the most likely issues from domestic banks.

There were ten corporate issues in August totalling AUD 5.35 billion with non-financials (Coles, Goodman Trust Australia, Korean Expressway Corporation and Aurizon Network) contributing AUD 1.8 billion of that amount. Financial issuance was predominantly subordinated capital-related deals (Suncorp, ANZ, IAG and QBE) with a few offshore issuers (Bank of China and Korean Development Bank) also accessing the market. Although supply of corporate paper has been steady for most of this year (apart from March), the total issued is about AUD 20 billion lower than the comparable period last year. It was a quiet month in the securitised market with only two issues totalling AUD 1.4 billion: a non-conforming RMBS from Pepper and an equipment loan securitisation from CNH Industrial.

Credit outlook

After a contraction in spreads over the last four months, credit is far less compelling than in March. The term of and response to the virus remain the core determinants of the outlook. With the current environment of uncertainty and nervousness as demonstrated by the resurgence of infections in Victoria, caution becomes a key requirement. Understanding of the different risks involved in individual credit issuers has become increasingly pertinent as the initial broad-based spread widening becomes increasingly refined depending upon the exposure of each issuer to the COVID-19 affected areas of the economy.

Both supply and demand are lower than last year but supply has been assisted by local non-financial issuers being more willing to access the domestic market. However, going forward until at least markets settle and outcomes from virus-related restrictions become clearer, it would seem likely that supply will be uncertain. Domestic non-financial supply is traditionally less abundant and is being tempted to offshore markets where government buying of credit has strengthened both demand and pricing of credit.

We believe the allocation to credit should be more weighted towards shorter dated credit which is less sensitive to spread movements. Given that, as mentioned earlier, the TFF will dampen local financial supply, domestic banks are less likely to access the market. For offshore issuers, caution must be applied due both to the long running issue of the complexity of the variations in treatment of capital requirements with varying rules on TLAC (total loss-absorbing capacity) and to the different levels of impact of COVID-19 in the markets.

Accordingly, although domestic banks offer a simpler value proposition, supply is uncertain and they are likely to become increasingly expensive. Hence, offshore financials are becoming an important part of the investment universe. On the non-financial side, airports and airlines are the most obvious sectors to avoid but even the less immediately exposed issuers must be scrutinised very carefully for indirect impact from the expected economy downturn. Securitised product would appear to be a potential area of value, but even with these a thorough examination of structure and assets is necessary and supply may be threatened by competition from the TFF.

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Important Information