

# Australian fixed income monthly October 2020

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## Australian market commentary

The Australian bond market (as measured by the Bloomberg AusBond Composite 0+ Yr Index) returned 0.28% over the month. The yield curve steepened as 3-year government bond yields ended the month 4 basis points (bps) lower at 0.12%, while 10-year government bond yields rose by 4 bps to 0.83%. Short-term bank bill rates were all lower. The 1-month rate was 4 bps lower, the 3-month rate was down 3 bps, while the 6-month rate was 5 bps lower at 0.07%. The Australian dollar was weaker, closing the month at USD 0.70.

In October, 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's Term Funding Facility has extended AUD 83 billion in funds to date. These measures are intended to keep funding costs low and sustain credit availability.

Domestic economic data releases in October were somewhat better than expected. Employment fell by 29,500 positions in September, exceeding market expectations. The unemployment rate ticked up to 6.9%, which was also better than expected. The Q3 headline CPI rebounded, to be up 1.6% for the quarter, while the annual rate stands at 0.7% which was in line with consensus expectations. The NAB Survey of Business Conditions showed improvement, rising 6 points to 0 in September, with business confidence also rising to -4 (from -8). Retail sales were down 4.0% in August. National CoreLogic dwelling prices put the brakes on recent declines, ending the month up 0.2%.

## Australian market outlook

The outlook for both the Australian and global economies continues to be clouded by the COVID-19 crisis. Despite the severe contraction in Q2 GDP which has seen Australia enter recession, the downturn is not as severe as previously expected and a recovery appears to be under way. The RBA has updated its economic forecasts as a result, with expectations of 4% GDP growth in the year to June 2021, and unemployment expected to peak closer to 8% in the next year, rather than the 10% previously expected. Inflation is expected to remain subdued, at 1% in 2021.

The Australian Federal Budget was released on 6 October, with increased spending and tax cuts to aid the economy as it recovers. 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, with AUD 214 billion of financing required (11% of GDP).

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. With markets having increasingly priced in

further easing, the RBA finally delivered a rate cut and additional measures to support the recovery at its 3 November meeting. The cash rate was cut from 0.25% to 0.10%, as was the 3-year yield target. The RBA also announced that it will buy AUD100 billion of government bonds (largely around the 5- to 10-year maturities) over the next six months. The program will include bond purchases of both the Australian Government and the states and territories, with an expected 80/20 split.

According to APRA, loan deferrals totalled AUD 179 billion, or approximately 6.7% of total loans outstanding (as at 30 September 2020). The majority of the deferrals by dollar value (over 70%) are housing loans, however the incidence of deferrals is higher in business loans (10.8%) than it is for housing (7.4%). APRA 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. On a positive note, exits from deferral continued to outweigh new entries for the third straight month.

### Credit commentary

October was a volatile month for credit as US and European markets waxed and waned with news on the pandemic and the US election. Spreads in US and European synthetic indices finished wider over the month while Australian credit markets, both synthetic and physical, rallied. Domestically, physical spreads to Government tightened about 10 basis points (bps) while in synthetic markets, the Australian iTraxx tightened 6.5 bps whereas the US CDX and the European iTraxx both widened by about 6 bps.

APRA's September loan deferral data was released with AUD 133 million of home loans or 7.4% of total home loans remaining outstanding (down from 9% in August and 11% at the peak in May) and AUD 35 billion of SME loans, or 10.8% to total loans (down substantially from 16% in August and 18% at the May peak). This was consistent with reporting from ANZ Bank, Bendigo Bank, Commonwealth Bank and Firstmac.

ANZ's reporting also highlighted the effect of the Term Funding Facility (TFF), that has kept the banks heavily awash with liquidity that not only highlights that banks are unlikely to issue senior or securitised product in the next year but also that lending remains slow. The only likely area of issuance as flagged by ANZ is Tier 2 debt. The first round of the TFF saw AUD 83.3 billion drawn down of the AUD 84 billion available. At this stage very little has been drawn down of the next stage, again emphasising that lending is not pressuring liquidity.

Ratings actions were relatively muted over the month, AMP Group Holdings and AMP Group Financial Services were downgraded to Baa2 from A3 and AMP Bank Ltd was downgraded to Baa2 from A3 by Moody's (due to the downgrade of affiliate support provider AMP Group Holdings).

All ratings are now stable. Coca-Cola Amatil Ltd had its A3 ratings placed on review for a downgrade from Moody's following Coca-Cola European Partners plc announcement that it had made a non-binding proposal to acquire the company for an EV of Coca-Cola European Partners PLC, which subsequently had its BBB+ rating placed on Ratings Watch Negative by Fitch. Crown had its Baa2 rating placed on review for downgrade by Moody's while Fitch moved its outlook on the BBB rating to negative. Dampier-Bunbury Natural Gas Pipeline (DBNGP) had its Baa2 rating placed on review for upgrade by Moody's

Offshore, the UK sovereign rating was downgraded to Aa3 from Aa2 by Moody's with the outlook now stable. This was followed up with negative actions on six UK banks including HSBC, Lloyds and Santander. Barclays had both their operating and holding company ratings removed from Rating Watch Negative by Fitch, and the outlook on both ratings is now negative. Similarly, BNP Paribas SA had its A+ rating affirmed by Fitch and was moved from Rating Watch Negative to negative outlook. Morgan Stanley had its A2 senior ratings placed on review for an upgrade by Moody's.

Given the lull in ratings action, reports were forthcoming. The two most relevant were Fitch's "Airports May Not Fully Recover Until late 2024" which noted that global airport traffic levels may not recover to pre-pandemic levels until 2024 and Standard & Poor's "Australian Banks Confront A Protracted Recovery" which highlighted stresses on Australian banks but did not signal an expectation of ratings actions on the back of them.

Positively, updates from GPT Group, Stockland Group and Shopping Centres Australasia suggest an improving environment for retail A-REITs although Mirvac (unsurprisingly) sounded a note of caution on CBD Melbourne.

There were 12 corporate issues in October totalling AUD 4.14 billion with non-financials (Port of Melbourne, CPIF and Lendlease) contributing AUD 1.35 billion of that amount. Financial issuance, with a few offshore issuers (United Overseas Bank, Mizuho, Woori Bank and Bank of China), contributed the bulk of the financial supply. Although supply of corporate paper has been steady for most of this year (apart from March), the total issued is about AUD 21 billion lower than the comparable period last year. After a busy September, October issuance in the securitised market was even stronger with 10 issues totalling AUD 5.9 billion. This comprised two non-conforming RMBS (AFG, and Liberty), two non-ADI prime issues (Firstmac and Pepper I-Prime), one non-resident loan RMBS (Vermilion), two ABS (Brighte and Allied Credit) and one SME CMBS (Think Tank).

### Credit outlook

After a contraction of spreads since March, credit is less compelling. A half year after the pandemic closed Australia, the term of and response to the virus remain uncertain and are the core determinants of the outlook. Although Australia seems to be in a good position, a current environment of uncertainty and nervousness remain, encouraged by the resurgence of infections in both the US and Europe. Caution has become a key requirement for viewing markets. For credit investors, understanding the different risks involved in individual credit issuers has become increasingly pertinent as an initial broad-based spread widening now 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 domestically 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 the demand and pricing of credit.

We believe allocation to credit should be more weighted towards shorter dated credit, which is less sensitive to spread movements. Given that the RBA's Term Funding Facility will limit the need for 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 each of 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 economic 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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