By Darren Langer,
Senior Portfolio Manager

nikko am
Nikko Asset Management

FROM THE AUSTRALIAN FIXED INCOME DESK

Australia Market Commentary

The Australian bond market (as measured by the Bloomberg AusBond Composite 0+ Yr Index) was down 0.42% over the month. The yield curve steepened as the spread between long-term and short-term bond yields widened. 3-year government bond yields ended the month up 7 basis points (bps) while 10-year government bond yields were up 15 bps to 2.67%. Short-term bank bill rates ended the month lower. The 1-month rate was up 2 bps to 1.88%, the 3-month rate was down 1 bp to 1.94% while the 6-month rate was unchanged at 2.14%. The Australian dollar remained unchanged for the month at USD 0.72.

During the month, the Reserve Bank of Australia (RBA) maintained the cash rate at 1.50%. The RBA continues to maintain its view on the economy with global growth continuing and global inflation remaining low.

Domestic economic data releases were mixed in September. GDP growth in the June quarter was ahead of expectations, recording growth of 0.9%. The annual rate was up 3.4%, the fastest annual expansion rate since Q3 2012. Employment rose by 44,000 positions in August (mostly in full-time positions). Meanwhile the unemployment rate remained steady at 5.3%. The NAB Survey of Business Conditions rose to +15 in August, however business confidence fell 3 points to +4, the lowest level since 2016. Retail sales disappointed, with a flat result for July.

Australia Market Outlook

Despite signs of improvement in key global economies, we remain cautious given ongoing geopolitical risks and shifting central bank policy settings. The US Federal Reserve raised the federal funds rate by 25 bps and the European Central Bank continues to reduce the pace of their QE tapering, with the program set to end in December. Concerns remain around the fragility of Europe with the UK's Brexit plan again being rejected by the European Union. The US instigated trade war remains ongoing, as the US continues to impose new tariffs, and targeted countries continue to retaliate.

The Australian economy continues to grow and has officially completed 26 years of uninterrupted expansion. We expect the monetary policy easing that took place in 2016 to continue to support a slow but robust growth environment.

Over the past six months the consumer has struggled despite a strong business and employment outlook. Corporate profits are robust and business confidence is high, however historically low retail sales and poor consumer confidence driven by very low wages growth makes the outlook for growth quite mixed.

We expect the RBA to continue to keep rates on hold into 2020. In the bond market, we expect Australian bond yields to follow global yields higher. Provided there is no sharp sell-off in risk assets we would expect credit spreads and swap spreads to remain well supported.

Credit Commentary

Credit was slightly volatile over the month as sentiment waxed and waned on the impact of the potential trade wars. However, spreads in most markets finished relatively close to the levels where they began at the start of the month.

Australian physical spreads widened 1-2 bps on average and the Australian iTraxx was 1.3 bps wider. In offshore markets, US CDX was wider by 0.5 bps and the European iTraxx tighter by 1 bp.

In credit news, banks continued to provide headlines with ANZ, Commonwealth Bank and Suncorp following Westpac's lead in raising their standard variable mortgage rates. NAB decided not to follow the others and held its rates fixed, as an attempt to "build trust".

Westpac was fined AUD 35 million by ASIC after admitting to wrongly assessing people's ability to repay mortgages. ASIC also launched proceedings against ANZ for allegedly breaching its continuous disclosure responsibilities during its 2015 share sale. The Commonwealth Bank has signalled an exit from Self-Managed Super Fund lending.

Moody's released its report on the Australian banking system and maintained a stable outlook due to the favourable economic environment although acknowledging risks from potential slowing credit growth, increasing profitability and rising funding and operating costs.

On last working day of the month, Commissioner Hayne's interim report of the results of the Banking Royal Commission was released: while heavily critical of many financial institutions and of the regulators, it stopped short of recommending substantially more regulation suggesting rather better enforcement of existing regulations.
Outside the financial sector, Telstra's fixed line services are being reviewed by the ACCC with the risk of changes to the

conditions that they operate under. Transurban's agreement to buy 51% of the WestConnex toll road has been priced at AUD 9.3 billion of which AUD 4.2 billion is funded by a rights issue. Standard & Poor's and Moody's both signalled that it would not impact ratings. Oxford Properties has entered the chase for Investa Office Fund (IOF), competing with Blackstone, with an initial bid of AUD 5.50 raised to AUD 5.60 after a counter offer was made. IOF management is still recommending the Blackstone offer.

Credit issuance for the month was AUD 8.1 billion down from AUD 12.9 billion the previous month though still at the high end of monthly issuance. Non-financial issuance (AUD 1.675 billion) included Paccar, GPT and AT&T while financial issuance came from Suncorp, AMP, MUFG Bank, Westpac, NAB, Toronto Dominion, Svenska Handelsbanken and Liberty Financial. In the securitised market there was AUD 2.7 billion of issuance from Commonwealth Bank's Medallion Trust, Liberty and RedZed. The Medallion Trust deal was AUD 1.63 billion, out of which the senior AUD 1.5 billion tranche was privately placed. The deal had a three year revolving period resulting in the senior tranche have a 6.5 year weighted average life (WAL) and a 9.2 year WAL for the other tranches.

Credit Outlook

Credit spreads seem to have settled wider than the tight levels at the start of year and are now closer to their post-financial crisis historical average levels across most jurisdictions and sectors, although still on the tighter side. At these spreads, any global or economic uncertainty will create increased widening pressure and recent uncertainty is putting pressure on spreads. Underweighting credit for any sustained period of time has become more expensive as spreads widen.

Despite a two month hiatus in June and July, supply in Australia has been very strong both in the financial and non-financial sectors, though this seems to have been met by demand and spread widening has been constrained to this point. Future domestic non-financial supply is, however, always uncertain given many Australian investment-grade issuers tend to be lowly geared and so require less debt. In addition, the bank loan market remains attractive for shorter maturities and offshore markets offer competitive pricing for sizable long-term debt issues. Many issuers have also taken advantage of low rates to refinance much of their maturities and the short-term corporate pipeline is thin.

Offshore, supply in the US market has remained strong despite a relatively quiet July and offshore markets, are in general, not as exposed to the lack of supply of non-financials as the Australian market.

Given the relative tightness of spreads, caution needs to be applied especially when investing in lower-rated credits. Despite the differing performance in terms of ratings, high-yield spreads are reasonably tight and the extent of compensation for taking exposure to lower-rated credit is less compelling.
Our preferred sectors remain domestic or select Asian banks, RMBS and the stronger utilities. Select offshore banks can also provide strong opportunities but caution must be taken due to the difficult operating environments and regulatory uncertainty for banks in many jurisdictions.

United States: This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. Nikko Asset Management Asia Limited is a regulated entity in Singapore.

Hong Kong: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

Australia: Nikko AM Limited ABN 99 003 376 252 (**Nikko AM Australia**) is responsible for the distribution of this information in Australia. **Nikko AM Australia** holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice.

New Zealand: Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme, Nikko AM NZ Wholesale Investment Scheme and the Nikko AM KiwiSaver Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website www.nikkoam.co.nz).

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Bank group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document nether constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree80/98, nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.