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FROM THE AUSTRALIAN FIXED INCOME DESK

Australia Market Commentary

The Australian bond market (as measured by the Bloomberg AusBond Composite 0+ Yr Index) was up 0.48% over the month, outperforming Australian equities which tumbled over 6%. The yield curve steepened marginally as the spread between long-term and short-term bond yields widened. 3-year government bond yields ended the month down 6 basis points (bps) while 10-year government bond yields were down 4 bps to 2.63%. Short-term bank bill rates ended the month lower. The 1-month rate was down 3 bps to 1.85%, the 3-month rate was down 3 bps to 1.91% while the 6-month rate was down 7 bps to 2.07%. The Australian dollar was lower, closing the month at USD 0.71.

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 broadly positive in October. Inflation eased with the Q3 CPI recording a 1.9% increase year-on-year, in line with expectations. Employment rose by 5,600 positions in September (mostly in full-time positions). Meanwhile the unemployment rate fell to a six year low of 5.0%. The NAB Survey of Business Conditions remained strong at +15 in September and business confidence rose 1 point to +5. Retail sales were up 0.3% in August, marginally ahead of expectations.

Australia Market Outlook

Global growth has desynchronised and we remain cautious given ongoing geopolitical risks and shifting central bank policy settings. The US Federal Reserve tightened monetary policy further in October by increasing the cap it uses to determine the amount of principal it reinvests on the maturity of its securities and the European Central Bank continues to reduce the pace of their QE tapering, with the program set to end in December. The US instigated trade war remains ongoing, as the US continues to impose new tariffs, and targeted countries continue to retaliate. However the US, Canada and Mexico revised their North American Free Trade Agreement during the month, with the impact on the automotive industry looking to be meaningful.

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

A risk off tone dominated the major global bond markets given the sharp sell-off in equities during October. The risk off tone caused rallies in bond markets and subsequently most indexes performed well, with the Bloomberg AusBond Credit Index gaining 0.48%. Offshore corporate credit spreads in USD and EUR both widened by 14 bps during the month. Offshore financials also widened by 7 bps (USD) and +13 bps (EUR). AUD spreads across both corporates and financials held firm, remaining unchanged over the month – most likely reflecting that there was not strong local primary issuance during this period of market volatility. Australian iTraxx was 7.1 bps wider, outperforming US CDX (9.4 bps) but underperforming the European iTraxx (5.1 bps).

In credit news, the major banks and insurers dominated news post the release of the interim report by the Royal Commission in late September. ANZ Bank announced in early October that its FY18 results would be impacted by an AUD 697 million after-tax charge for customer compensation, legal costs of the Royal Commission, IT and other expenses. On 31 October, ANZ Bank announced its full year results: cash earnings were AUD 5.8 billion, down 16% year-on-year ('YoY'). Earnings were flat YoY on a statutory basis. Capital improved in FY18, with CET1 ratio increasing by 87 bps over the year to 11.4%.

In an apparent response to the anticipated outcomes of the Royal Commission, the major financial institutions are undertaking some asset sales to "simplify" their operations. AMP announced that it will sell its wealth protection and mature businesses (AMP Life) to UK based life insurance company Resolution Life for AUD 3.3 billion and has also entered into a binding agreement with SwissRe to reinsure its NZ retail wealth protection business. ANZ Bank had previously announced the sale of parts of its wealth management business to IOOF. Commonwealth Bank and NAB are seeking buyers for parts of their wealth management businesses.

In other local corporate news, Vicinity announced the sale of 11 regional centres for total proceeds of AUD 631 million. Wesfarmers released its scheme booklet for the demerger of Coles – Wesfarmers will retain 15% interest in Coles. We expect Wesfarmers to retain its existing rating of A-/A3 post demerger. Transurban released its September quarter update, advising that Average Daily Traffic had increased by 3.3%, with growth experienced across all markets. Transurban also announced that its consortium had completed the acquisition of a 51% stake in WestConnex, funded by AUD 4.8 billion equity raising.

In offshore news, many of the major US banks provided their Q3 results in October: JP Morgan, Citigroup, Bank of America, Goldman Sachs, and Morgan Stanley all reported results that were regarded as "solid" or "exceeded expectations", driven mainly by good growth in revenues from rising interest rates and asset growth, and from lower provisions.

In October, General Electric Co ("GE") was downgraded by S&P to 'BBB+' from 'A', given they expect GE's operating performance of its power business will be below expectations. BHP Billiton was upgraded from A2 to A1 (with Stable Outlook) by Moody's.

Credit issuance for the month was AUD 3.0 billion, well down on AUD 8.1 billion the previous month reflecting the cautious approach by issuers given the volatility in equities markets during the month. Non-financial issuance (AUD 725 million) comprised Port of Melbourne (AUD 550 million) and Heathrow Airport (AUD 175 million), both of which are new issuers in the local bond market. Financial issuance came from Bendigo & Adelaide Bank, Korea Development Bank, Bank of Communications, Bank Federative du Credit Mutuel, Newcastle Permanent Building Society, and Suncorp. In the securitised market there was combined AUD 2.3 billion of issuance from Pepper (AUD 600 million, Pepper's second prime deal for 2018), Firstmac (AUD 1 billion, Firstmac's third deal for 2018) and Credit Union Australia (AUD 700 million). All three securitised deals were prime RMBS.

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. At these spreads, global or economic uncertainty is creating increased widening pressure. Underweighting credit for any sustained period of time has become more expensive as spreads widen.

Following relatively strong issuance in August and September, supply in October was much quieter against a backdrop of market uncertainties and declining equity markets. As noted previously, 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 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 in the US still appear slightly tight and in Europe are close to normal but vulnerable to further widening; as such, 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.

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