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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 0.24% over the month, outperforming Australian equities which fell over 2%. The yield curve flattened marginally as the spread between long-term and short-term bond yields narrowed. 3-year government bond yields ended the month up 2 basis points (bps) while 10-year government bond yields were down 4 bps to 2.59%. Short-term bank bill rates ended the month higher. The 1-month rate was up 3 bps to 1.88%, the 3-month rate was up 4 bps to 1.95% while the 6-month rate was up 6 bps to 2.13%. The Australian dollar was higher, closing the month at USD 0.73.

During the month, the Reserve Bank of Australia (RBA) maintained the cash rate at 1.50%. The RBA has upgraded its view on the economy with forecasts for economic growth revised upwards for 2018 and 2019. Further reductions in unemployment and a return to target inflation is also expected.

Domestic economic data releases were mixed in November. Employment rose by 32,800 positions in October (mostly in full-time positions). Meanwhile, the unemployment rate held steady at 5.0%. The NAB Survey of Business Conditions eased 2 points to +12 in October and business confidence fell 2 points to +4. Retail sales were sluggish, up 0.2% in September, which was below 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 kept the federal funds rate on hold in November 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, despite the temporary truce called between the US and China at the recent G20 Summit.

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 remains positive, 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

Globally, credit had a weak month as the news flow moved between positive and negative themes. A more dovish US Federal Reserve was offset by swings in mood over the trade wars as President Trump's tweets and other statements moved sentiment back and forth.

Ultimately, offshore corporate credit spreads in USD and EUR both widened by over 20 bps over the month while the higher credit quality Australian market widened 7 bps. The Australian iTraxx was 4.5 bps wider, outperforming US CDX (+6.5 bps) and European iTraxx (+7 bps).

In more specific credit news, APRA flagged its Total Loss Absorbing Capacity (TLAC) framework which would see need for a further 400-500 bps of extra loss-absorbing capital. APRA expects this to be met in the Tier 2 market. In banking offshore, the European Bank Authority released its stress tests results which no bank failed. Westpac, CBA and Macquarie all updated the market with results which were broadly in line with expectations but show credit costs falling.

Wesfarmers' shareholders approved the demerger of Coles. Standard & Poor's has indicated a BBB+ rating for the demerged entity and Moody's similarly has indicated Baa1. Woolworths reported weak 1Q19 same store growth but flagged expectations that competitive pressures will diminish as the two major supermarkets limit cost cutting, especially following the demerger. Woolworths also announced, subject to regulatory approval, the sale of its fuel business to UK-based EG Group. Coca Cola Amatil announced that it will be divesting SPC.

In the utility sector, the Australian Energy Regulator approved new 2019 tariff proposals. Although setting lower revenue, the regulator allowed some tariff increases to enable capital investment for the safe and reliable maintenance of service. S&P removed the positive outlook for APT Pipelines after the Federal Government rejected Hong Kong-based CKI's bid for the APA Group.

LendLease had a rough time with bond investors after pricing an AUD 500 million deal but having to cancel it on settlement day after it announced an AUD 350 million NPAT provision. Stockland divested two town retail centres and is looking to sell another AUD 290 million in the next year, as it re-weights into logistics and funds a share buyback. Scentre is also reported to be considering spinning off some suburban shopping centres as a means of recycling capital.

Moody's took positive action on Rio Tinto moving its A3 rating to review for upgrade. Earlier Moody's had upgraded BHP Billiton to A2 from A3.

In securitisation news, the federal government indicated plans to inject AUD 2 billion into an SME securitisation fund.

Offshore, GE's woes continued with a downgrade by Moody's to Baa1 following on from S&P's downgrade last month. The SEC is investigating accounting irregularities in the company. Nissan also hit the headlines with the firing of its chairman, Carlos Ghossen, for allegations of breaching Japanese financial law. Nissan and Renault expressed commitment to their 20-year alliance. S&P placed Nissan on CreditWatch Negative. General Motors announced plans to cut 14,000 jobs creating displeasure with the Trump administration.

Credit issuance for the month was AUD 12.6 billion lifting from a low of AUD2.6 billion the month before and surpassing the issuance in calendar 2017. Issuance over the month, however, was exclusively financials, leaving total non-financial corporate issuance for 2018 at AUD 9.2 billion, about half of the previous year's supply. In securitisation, seven public deals were priced with a total value of AUD 4.7 billion – a prime RMBS from Resimac, three non-confirming RMBS (from Pepper, La Trobe and Bluestone), two auto deals from Metro Finance and REDS EHP and an SME CMBS from Think Tank. The Pepper RMBS stood out for having a green tranche.

Credit Outlook

Credit spreads widened again but are still substantially tighter than the levels of 2015. As such, there is room for further widening in an environment where global or economic uncertainty is continues to apply pressure. However, underweighting credit for any sustained period of time has become more expensive as spreads widen.

Supply in 2018 has now exceeded that of the previous year, boosted by strong issuance from the major banks and other financials. As noted previously, 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 weakness 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 reasonably 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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