Australian Fixed Income Monthly
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Australian market commentary

The Australian bond market (as measured by the Bloomberg AusBond Composite 0+ Yr Index) returned -0.11% over the month. The yield curve steepened as 3-year government bond yields ended the month 1 basis point (bp) lower at 0.11%, while 10-year government bond yields rose by 7 bps to 0.90%. Short-term bank bill rates were all lower. The 1-month rate was 3 bps lower at 0.02%, the 3-month rate was down 4 bps at 0.02%, while the 6-month rate was 5 bps lower at 0.02%. The Australian dollar was up sharply, closing the month at USD 0.74.

With markets having increasingly priced in further easing, the Reserve Bank of Australia (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 would purchase 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. During the month, the RBA purchased AUD19 billion of government bonds under the bond purchase program and a further AUD5 billion of Australian government securities in support of the 3-year yield target.

Domestic economic data releases in November were mostly upbeat. Employment rose by 178,800 positions in October, significantly exceeding market expectations for a fall in employment. The unemployment rate ticked up to 7.0%, which was also better than expectations. The NAB Survey of Business Conditions showed improvement, rising to 1 in October (from 0 the previous month), with business confidence also turning positive, rising to 5 (from -4). Retail sales were down 1.1% in September. National CoreLogic dwelling prices saw a second consecutive monthly rise in November, ending the month up 0.8%.

Australian market outlook

November saw renewed hope for both the Australian and global economies as potential COVID-19 vaccines are rushed to market. However, question marks remain about how quickly any vaccines will be rolled out and the willingness of the population to be early adopters of a new vaccine.

Despite a severe contraction in Q2 GDP which saw 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 2021 and 5% growth in 2022. Unemployment is 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. We believe there could be upside risk to the inflation forecast, given recent increases in commodity prices and rising house prices which are being supported by record low interest rates.

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. Lower interest rates should assist the recovery through the following: lower financing costs for borrowers, a lower exchange rate than otherwise and support for asset prices and balance sheets. The Term Funding Facility is also supporting the supply of credit to businesses.

According to APRA, loan deferrals totalled AUD 88 billion, or approximately 3.3% of total loans outstanding (as at 31 October 2020), a sharp improvement from 6.7% in the month prior, as exits from deferral continued to outweigh new entries. The majority of the deferrals by dollar value (over 75%) are housing loans, however the incidence of deferrals is higher in business loans (4.5%) than it is for housing (3.9%). 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.

Credit commentary

The news cycle was dominated in early November by the US election held on 3 November, with Joe Biden likely to be the next US president. President Donald Trump has refused to concede, citing unsubstantiated voter fraud. It is expected that Mr Biden will be confirmed as the clear winner by mid-December when the Electoral College votes are finalised. In late November, the dominant theme was positive news regarding the field trials of three new vaccines to deal with the COVID-19 pandemic, with the manufacturers seeking US FDA approval to accelerate roll out of the vaccine for distribution in early 2021.

The US election result, positive vaccine news and the reopening of Victoria triggered a very strong rally in spreads. Australian bonds sold off as the positive news on the vaccines dominated markets, with the credit markets having their best month this year. AUD non-financial spreads rallied 30 bps and financial spreads rallied 13 bps, on average. Industries which have lagged in this year's rally, such as retail REITs, airlines and airports, all outperformed in November.

National Australia Bank, Westpac and Commonwealth Bank (CBA) all reported financial results during the month. While earnings were down on previous years due to higher (COVID-19 related) provisions, the banks remain well capitalised with core equity tier 1 capital of above 11%. APRA announced it was reducing the 'additional risk overlay' applicable for CBA from AUD 1 billion to AUD 500 million (in line with the other major banks), given the improvements CBA has made in implementing its remedial action plan following the ATM money laundering scandal in 2017 and 2018.

Primary bank issuance picked up following the release of full year results with about AUD 8 billion in issuance, though this was largely tier 2 paper in US markets. Domestic issuance by ADIs was still dampened by high liquidity from the build-up in their substantial deposit funding bases and by their access to the RBA's Term Funding Facility (where AUD 106 billion is available in undrawn 3-year funding).

In early November, APRA confirmed that the Committed Liquidity Facility (CLF) would be reduced in size by AUD 25 billion to AUD 188 billion, citing that this reflected improvements in ADI funding and liquidity and their expectation that government debt would continue to increase beyond 2021 and so the CLF may not be required in the foreseeable future.

There were nine credit issues in November totalling AUD 4.53 billion with non-financials (Australian Gas Infrastructure Finance (AGIF), Australian Catholic University and NBN Co) contributing AUD 2.15 billion of that amount (AUD 1.95 billion of this was for first time issuers: NBN Co for AUD 1.2 billion and AGIF for AUD 750 million). Financial issuance of AUD 2.3 billion during November was dominated by tier-2 issuance by National Australia Bank (AUD 1.25 billion) and Bendigo & Adelaide Bank (AUD 150 million). Bendigo & Adelaide Bank also issued an AUD 650 million senior unsecured FRN in November, the first senior unsecured AUD issue since May. Met Life also issued (AUD 500 million) in this market for first time in many years. Although supply of corporate paper has been steady for most of this year (apart from March), the total issued is about one third lower than the comparable period last year given the sharp decline in financial issuance as ADIs build up deposits and utilise Term Funding Facility from RBA. After a busy September & October, issuance in the securitised market was much reduced at total AUD 1.2 billion across 2 non-ADI RMBS issues (Pepper and Ruby).

Ratings actions over the month included Coca-Cola Amatil Ltd having its BBB ratings placed on Credit Watch by Standard & Poor's (S&P) following last month's announcement from Coca-Cola European Partners plc that it had made a non-binding proposal to acquire the company. Due to increased regulatory concerns, Crown was downgraded one notch by Moody's to Baa3 (with Negative Outlook), while S&P placed its BBB rating for Crown on

Credit Watch Negative. Ratings were assigned to new borrowing vehicle AGIF of A3 and BBB+ by Moody's and S&P, respectively, both with Stable Outlook. AGIF is the borrowing vehicle for Australian Gas Infrastructure Holdings, which includes Energy Partnerships and Dampier-Bunbury Natural Gas Pipeline (DBNGP) group—their ratings were aligned with AGIF (this resulted in DBNGP being upgraded 1 notch to A3 by Moody's and to BBB+ by S&P).

Other issuers to receive new ratings during November included NBN Co (rated A1 by Moody's and AA by Fitch), Defence Bank (rated Baa1 by Moody's) and Western Sydney University (rated Aa2 by Moody's).

Credit outlook

After a contraction of spreads since March, and further step-down in November, credit is less compelling.

While Australia has done well to contain the community spread of COVID-19, the level of economic activity is still in recovery phase, helped by substantial Federal and state government support programs. The local optimism of a path forward given gradual relaxation of social restrictions, reopening of inter-state borders and potential vaccines in near future, is still somewhat clouded by the unknown impact of expected run-off in these various government support programs and the recent resurgence of infections in both 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 has now been almost completely reversed and spread movements have become 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 any protracted delay in the local economic recovery. 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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