Australian Fixed Income Monthly
February 2021

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Australian market commentary

The Australian bond market (as measured by the Bloomberg AusBond Composite 0+ Yr Index) returned -3.58% over the month. The yield curve steepened dramatically as 3-year government bond yields ended the month 1 basis point (bp) higher at 0.12%, while 10-year government bond yields spiked by 79 basis points (bps) to 1.92%. Short-term bank bill rates were marginally higher. The 1-month rate was steady at 0.01%, the 3-month rate was up 2 bps at 0.03%, while the 6-month rate was 4 bps higher at 0.06%. The Australian dollar was stronger, closing the month at USD 0.78.

Monetary policy settings remained unchanged in February, as the Reserve Bank of Australia (RBA) maintained both the cash rate and the 3-year yield target at 0.10%. The RBA also indicated it will purchase an additional AUD100 billion of bonds issued by the Australian government and states and territories when the current bond purchase program is completed in mid-April.

Domestic economic data releases in February were mostly upbeat. Employment rose by 21,900 positions in January. The unemployment rate ticked lower to 6.4%, which was better than expected. The NAB Survey of Business Conditions fell to 7 in January. Business confidence, however, jumped to 10, which is well above the long run average. Retail sales were down 4.1% in December. National CoreLogic dwelling prices saw a fifth consecutive monthly rise in February, ending the month up 2.1%, with regional housing values continuing to outpace capital cities, although the gap has narrowed.

Australian market outlook

February saw continued hope for the recovery as 10-year bond yields surged on higher inflationary expectations, driven by an appreciating currency, higher commodity prices and expectations surrounding large US fiscal stimulus.

The economic downturn is not as severe as previously expected and a recovery is under way. The RBA has updated its central economic forecasts, with expectations of 3.5% GDP growth in both 2021 and 2022. Their forecast unemployment rate has also been revised down with expectations it will fall to 6% by year end. Inflation is expected to remain subdued at 1.25% in 2021. We believe there could be upside risk to the inflation forecast, given recent increases in commodity prices and also rising house prices which are being supported by record low interest rates.

The RBA remains committed to its current policy settings and has repeatedly stated that it is not expecting to increase the cash rate for at least 3 years. Lower interest rates should assist the recovery through lower financing costs for borrowers, a lower exchange rate than otherwise and support for asset prices and balance sheets. The Term Funding Facility (TFF) is also supporting the supply of credit to businesses.

The Australian economic outlook is highly dependent on how well COVID-19 will be controlled. Assuming the vaccine roll-out goes to plan, following what has been a slow start, we expect a moderate economic recovery as many lead indicators have now turned positive, including: business conditions, global PMI, employment indicators, lending statistics, retail sales, house prices and commodity prices. The key risk to the recovery is a stop/start economy if for any reason the vaccine roll-out does not go to plan. The impact on small businesses also remains to be seen when JobKeeper and JobSeeker cease at the end of March. From an external standpoint, the lack of international visitors and students also weighs on the outlook for the local economy, as does the trade war with China.

Credit commentary

Credit had tightened over most of February but largely returned to start of month levels over the last few days. Spreads on synthetic indices were virtually unchanged over the month with the US CDX and Australian iTraxx and the European iTraxx 1 basis point tighter. Physical credit spreads to government had tightened more substantially over the month but sold-off to be just slightly tighter by month-end.

The Term Funding Facility (TFF) had an AUD 5 billion drawdown, the first significant amount since the deadline for the initial allowance on 30 September. There is now AUD 94 billion of undrawn limit remaining based on the January allowance numbers. From Australian Prudential Regulation Authority (APRA) data, on a 3-month annualised basis, system lending growth was 2.8%; owner occupied residential lending grew by 7.1% while investor residential was up 1.6%, but loans to non-financial businesses declined by 2.6%. APRA also reported that 1.4% of loans remain in COVID-19 related deferral at the end of January, down from 1.9% at 31 December. For housing, 1.8% of loans were in deferral while SME loan deferrals were down to 1.1%. Victoria remained more challenged (2% of book compared to 1% for the remainder of the country) but the gap is narrowing post the extended lockdowns in that state. This is the last month for deferrals and so arrears rates next month will be impacted by any loans that remain affected. APRA also announced its priorities for 2021 after COVID-19 enforced delays in 2020. The supervisory angle will resume work on recovery and resolution planning, embedding stress testing capabilities within firms and the development of climate risk. On the policy front, APRA will resume work on the new capital framework.

Updates from Australian banks were generally better than expected both in terms of profits and in the extent of the worsening of asset quality. Westpac and ANZ both released provisions boosting net profit. Competition for loans is intense as banks look to deploy the cash from the TFF and the property market strengthens offshore. Canadian banks also released provisions as the economy improves and mortgage growth picks up. UK banks also reported better than expected profits, although they warned of headwinds to loan growth.

In the non-financial market, the reporting season showed credit metrics deteriorating but operating metrics for most companies starting to recover from the fallout of COVID-19. Total leverage in the system increased as earnings continued to decline. Cost cutting has continued. Operating cash flows have been increasing faster than earnings and dividend payouts have lifted. However, credit risks are stable for most sectors while M&A activities have remained low and many companies are looking to sell more assets to reduce balance sheet leverage.

In rating news, the NSW casino inquiry's recommendation to the NSW gaming regulator that Crown and its licensee are unsuitable to hold a gaming licence generated questions on its Western Australian and Victorian operations, resulting in it being placed on CreditWatch Negative by Standard & Poor's (S&P). The proposed acquisition of ME Bank by Bank of Queensland meant that ME Bank's BBB rating from S&P, and Baa1 rating from Moody's were placed on review for an upgrade. Woodside had its BBB+ rating affirmed and removed from CreditWatch Negative by S&P. Boral's Baa2 rating was affirmed by Moody's but moved it to a negative outlook. Fitch moved the outlook on Fonterra's A rating from Negative to Stable. Transpower NZ benefited by its sovereign's upgrade and was moved to AA from AA- by S&P. Toyota Motor Corp had its outlook revised to stable from negative by S&P. The company's A+ ratings were affirmed.

In securitisation news, spreads have tightened significantly as comfort on the resilience of most issues has increased, especially as COVID-19-affected loans continue to diminish to a manageable size. At the start of the month, S&P released its November SPIN report showing 90+ day arrears decreased 2bps to 0.54%. At the end of the month, the December SPIN data was released, showing 90+ day arrears increased 10bps to 0.64%.

As an improvement on the very low supply in January, six domestic corporate issues came to market in January with a total amount of AUD 3.09 billion. Most issuers were financial (Suncorp, UBS, Svenska Handelsbanken, Defence Bank and Newcastle Building Society) with one A-REIT issue from Charter Hall LWR. Securitisation saw only one issue: an AUD 1.5 billion Triton deal from Columbus.

Credit outlook

With spreads still at tight levels, credit looks expensive, especially in light of recent interest rate volatility. With the pandemic still a major issue and the roll-out of the vaccine becoming a global political stress-point, uncertainty and nervousness remain at the forefront, although Australia seems to be in a good position. For credit investors, understanding the different risks involved in individual credit issuers remains highly pertinent.

This year has been notable for the weakness in supply of new issues while demand has driven physical spreads tighter. Going forward until at least markets settle and outcomes from virus-related restrictions become clearer, it would seem likely that supply will be uncertain especially in the financials. Domestic non-financial supply is traditionally less abundant and has been often tempted to offshore markets where size and maturity are more flexible.

We believe allocation to credit should be more weighted towards shorter dated credit, which is less sensitive to spread movements—although the current tightness in the spreads for this maturity sector reduces the attraction. The RBA's TFF continues to limit the need for domestic banks 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 typically offer a simpler value proposition, they have become increasingly expensive and harder to source. Offshore financials are therefore 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 challenges to the economy. Securitised products, although also becoming more expensive, 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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