Australian Fixed Income Monthly January 2021

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Australian market commentary

The Australian bond market (as measured by the Bloomberg AusBond Composite 0+ Yr Index) returned -0.42% over the month. The yield curve steepened as 3-year government bond yields ended the month flat at 0.11%, while 10-year government bond yields rose by 16 basis points (bps) to 1.13%. Short-term bank bill rates were unchanged. The 1-month rate was steady at 0.01%, the 3-month rate was also unchanged at 0.01%, while the 6-month rate was steady at 0.02%. The Australian dollar was slightly lower, closing the month at USD 0.76.

Monetary policy settings remained unchanged in January, as there was no Reserve Bank of Australia (RBA) meeting during the month. The cash rate remains at 0.10%, as does the 3-year yield target.

Domestic economic data releases in January were mostly upbeat. December quarter inflation exceeded expectations to be up 0.9%. The annual inflation rate also stands at 0.9%. Employment rose by 50,000 positions in December, in line with market expectations. The unemployment rate ticked lower to 6.6%, which was better than expected. The NAB Survey of Business Conditions showed further improvement, rising to 14 in December. Business confidence however fell to 4, reflecting the impact of Sydney's December COVID-19 outbreak. Retail sales were up 7.1% in November. National CoreLogic dwelling prices saw a fourth consecutive monthly rise in January, ending the month up 0.9%, with regional housing values continuing to outpace capital cities.

Australian market outlook

January saw continued hope for both the Australian and global economies as COVID-19 vaccines are rushed to market. However, question marks remain about how quickly any vaccines will be rolled out given recent supply constraints 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 again 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 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 three 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 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, 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. Other risks include the early withdrawal of government stimulus if the data continues to look rosy. This includes the impact on small businesses when JobKeeper ceases and the end to JobSeeker, both expected 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

With markets diverted by the political fall-out from the US election and uncertainty about when the vaccine will be rolled out in various parts of the world, credit was to a large extent side-lined, especially in Australia where summer holidays further quietened the market. January saw synthetic spreads drift wider with the US CDX out by 6 bps, European iTraxx by 4 bps and Australian iTraxx by 5 bps. Domestic credit spreads were, on the other hand, slightly in with shorter-dated credit outperforming and now at very tight levels.

This month saw reports from three government sponsored programmes. The Committed Liquidity Fund (CLF) was set up by the RBA to ensure availability of sufficient high-quality liquid assets (HQLA) so that banks can meet regulatory liquidity requirements. The RBA signalled that the amounts available under this programme were being reduced given less demand and higher levels of alternative assets such as government bonds. The Structured Finance Support Fund (SFSF) was established to support both public and private securitisation markets. Public securitisations did not need the SFSF over the quarter. Private securitisation saw continued—although slowing—demand for warehouse facilities with four individual warehouse investments approved but also saw interest in replacing the Australian Office of Financial Management's (AOFM) positions with private sector investment. The AOFM also operates a Forbearance SPV as part of the SFSF to assist liquidity within COVID-19-affected issues. It was drawn down by five institutions over the December quarter but has only used AUD 45 million of the AUD 101.5 million allocated. The fact that the SFSF has been less used highlights the increasingly healthy nature of securitised markets. The third programme to report, the Term Funding Facility (TFF), was introduced to assist the banks with liquidity to enable them to be able to offer credit within the community. Total drawings under the facility remained quite static at AUD 84.7 billion with little movement since 30 September 2020. The RBA also updated on additional allowances under the scheme with the large business allowance down to AUD 17 billion from a peak of AUD 47 billion in June and the SME lending allowance also lower at AUD 30.9 billion down from AUD 37 billion in September. The banking sector's reluctance to draw down the TFF until the last moment highlights the excess liquidity in the system and weak credit growth in many sectors since the pandemic started.

In a quiet month for rating news, SingTel Optus Pty Ltd and Optus Finance Pty Ltd were downgraded by Moody's to A3 from A2 and their rating outlooks were revised to stable from negative. The downgrade reflects the deterioration in Optus's credit profile over 2020 and Moody's expectation of further deterioration. In the securitised sector, Moody's upgraded the ratings on 4 tranches in the Liberty 2019-1 RMBS due to an increase in credit enhancement and only a moderate level of loans in arrears or under COVID-19-related hardship payment arrangements.

Daimler AG had the outlook on its BBB+ rating revised to stable from negative by Standard & Poor's (S&P). S&P moved 15 major oil and gas companies, including Total and Woodside, to negative watch based on the view that there are significant challenges and uncertainty in the sector.

In other credit news, retail property manager Vicinity Centres provide an update on property valuation movements, announcing a 4% decline in total property values for H2 2020, taking the downward movement over the full COVID-19 period of 2020 to 14.7%.

Overall, the US reporting season matched expectations. US banks generally reported improving results, aided by releases of provisions but impacted by lower loan balances and increased deposits resulting in contracting margins.

Only two domestic corporate issues came to market in January: a new line from the University of Melbourne and a Tier 2 issue from Westpac. The new issue market for securitised product was quiet with only one issue in the pipeline for February.

Credit outlook

With spreads now at tight levels, credit looks expensive. 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 month demonstrated 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. Domestic non-financial supply is traditionally less abundant and has often been 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 to both the long running issue of the complexity of the variations in treatment of capital requirements with varying rules on total loss-absorbing capacity (TLAC) 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 have become increasingly expensive. 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 product, 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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