

→ Income & Fixed Interest Newsletter

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NIRP and other ill-fated ideas

February was a very volatile month across markets with the S&P closing the month largely unchanged after a violent fall in the first couple of weeks. There were numerous market drivers this month but the ongoing shift to negative interest rate policy (NIRP) in many countries was by far the most important. The move to negative rates faces many problems, as experienced by the BoJ which, having aggressively moved to this policy at the end of January, saw the Yen strengthen materially against their wishes in February.

Despite this it seems clear that the appetite for further NIRP has moved significantly forward post Davos, with the Riksbank pushing its rate more negative and the ECB telegraphing to markets to expect more easing at its March meeting. With the lack of faith in QE now absolute and fiscal policy action sadly unforthcoming, it was only a matter of time before central bankers needed a new toy to play with in the form of NIRP.

Given NIRP has only just been unwrapped and out of the box expect it to be used much more than markets are currently anticipating as world trade and world growth slow. We can easily see rates of -2% in many developed markets, making my 1% RBA call I made back in 2013 seem positively pedestrian.

Obviously as equities came under pressure in February and volatility picked up bonds performed well over the month, with 10yr JGBs

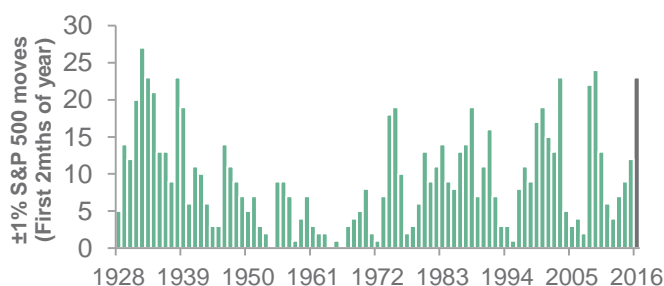
yields moving negative for the first time ever and 10yr Bund yields hitting all-time lows. US Treasuries yields are hovering just over all-time lows and technically look to be heading much lower. While we continue to favour long duration positions in bonds (especially in Europe) we think that short credit positions offer the best risk-reward in markets currently and have built material positions in these.

Chart 1: More negative bond yields



Source: Bloomberg

Chart 2: Already the most volatile period in years



Source: Bloomberg

Economic data over the month was generally weak with Europe and Japan the most disappointing and the highlight/ lowlight was

US CPI which has now turned up and will make the Fed's job a very tricky one in coming months, especially since the market has priced out all Fed tightening for 2016 now. We had a quiet month on the portfolios with all of our flagship funds producing returns close to benchmark over the month.

We have talked a lot about the declining liquidity in the markets, so wanted to focus this month on what exactly we mean and why we are so bearish on credit securities on the back of it. We will be covering this theme in depth at the annual BTIM Roadshow in May.

The myth and mystery of liquidity

The whole concept of liquidity is an odd one as it's incredibly difficult to define. For example it can be used to describe coverage ratios, bid-offer spreads, collateral fails, repo & GC rates, volumes, etc. etc. Unfortunately it's not an absolute number that can be calculated at all points in time as it is something that can change rapidly as conditions go from being strong to weak; when markets go from being elated to fearful; or when the structure of the market goes from one of being supportive of liquidity to detrimental to it.

Liquidity in markets can sometimes be described as an illusion, ready to evaporate at any given moment. In fact, the only true liquidity exists in those assets that are willing to be accepted by central banks as the liquidity provider of last resort, and even then these facilities are only available to the large broker-dealers or banks, and generally only in government bonds or similar. These windows were extended in Australia to highly rated mortgage backed securities in the GFC, but mostly as a backdoor to fund the banking system and are only a reflection of how seriously bad it was at the time.

Outside of these 'risk-free' assets though, the provision of liquidity falls back onto the private sector depending on the assets involved. For fixed income, which includes corporate bonds and asset-backed securities, the traditional

liquidity providers have been the large broker-dealers such as JP Morgan, Goldman Sachs and Deutsche Bank, with the major banks being fairly large supporters of the market domestically. These institutions are clearly for-profit and as such need to be incentivised to provide liquidity into this market so that fund managers, like us, can buy from their inventory when we need stock and sell back to them when we need to raise cash.

The middle men need to keep inventory due to the fact that there is no exchange, like the ASX or NYSE for equities, for these securities because of the huge number of different companies, different maturities, coupons and terms for these bonds. There are just too many securities to have a deep enough market for an exchange, so liquidity providers help to smooth out the supply and demand for these securities in normal markets.

The process of funding bonds

Keeping inventory though, just like for a bricks-and-mortar store or company, costs money. Let's say we, as a fund manager, want to sell a corporate bond (say Telstra bond with a maturity of 2021 for example). We request a bid for our position from different banks and brokers on this five year security. Once we have found the best price (or lowest yield) we can sell this security in return for cash to the broker and now the security is theirs. At this point the broker now has to fund the purchase of this security and also set aside a reserve for the risk that this security defaults while they are holding it. These two aspects can be costly and affect the level at which the broker can buy the security. These are two different concepts that are important to understand as they have (and will continue to) have a large effect on the corporate credit and fixed income markets.

Funding the purchase of a security is the first step. Since banks and brokers are leveraged institutions unlike (the majority) of funds we manage which are unlevered, for every dollar they spend to buy a security or to lend to a

corporate they need to borrow a majority of it from either depositors or the capital markets. All of these sources of funding merge together to form an average cost of funds, over which the bank must lend at to make profit (with some extra cream to account for the risk of that lending). Most marginal borrowing for the bank will come from capital markets since drumming up a huge amount of depositors on demand is a little bit difficult.

From the capital markets the bank has a choice of picking unsecured or secured funding to fund this newly bought Telstra bond. Borrowing on an unsecured basis involves going to the capital markets and convincing them to lend to the bank against the entirety of the balance sheet and all of its risk. The other option is secured funding, which means that the bank can get funding for the security that it just bought (the Telstra bond) by pledging just that bond itself rather than the whole balance sheet. This was a very prevalent form of lending pre-GFC, and the proliferation of what is called 'repo' funding is exactly what landed Lehman Brothers in so much trouble as it had an over-reliance on this type of funding.

This may already be confusing even if you are familiar with how much it costs different corporates and banks to borrow. A company like Telstra or Wesfarmers typically trades at a much lower yield than the banks or brokers do, meaning that unsecured funding would always cost too much to justify keeping inventory in any of these lower-risk companies. This is where the dirty trick of 'maturity transformation' occurs, which is where banks generate most of their money from and where much of their liquidity risk arises.

The Telstra bond they just bought won't be funded until its maturity in 2021, but only for maybe 1-3 months. Since a bank's funding for that period is considerably cheaper in terms of credit premium, all of a sudden buying the Telstra bond becomes a viable plan again. The idea behind secured or 'repo' funding is the same, however the terms of this lending is

usually even shorter, measured in days rather than months.

You might be thinking that borrowing short to lend long sounds like a dangerous game to play, and it most definitely is, but it is the model that banks use. Since most of the assets of the bank are almost impossible to sell, any slight interruption in funding can bring the whole structure down as it relies on continuous rolling of short-term funding. This means that the market always needs utmost confidence in any financial institution.

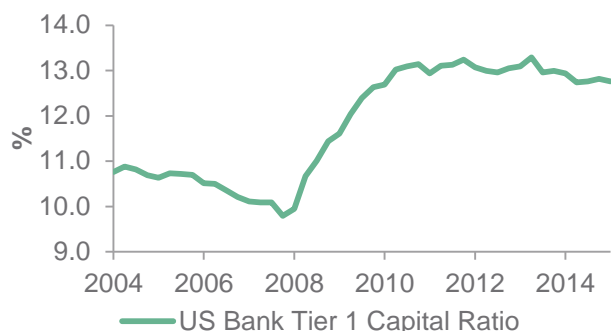
No more backstops

In the past the creditors of the banks relied upon the assumption that the government would step in to provide liquidity to the bank if it got into trouble. This obviously ended with Lehman Brothers and has now basically been enshrined into law in a number of regions by making bank bonds able to be 'bailed-in', which means that unsecured bank lenders need to accept losses when a bank fails whether due to running out of liquidity or capital. Losses are taken to buy time while the bank is unwound and assets are sold. While this removes the state from having to be in a position of moral hazard when deciding which banks it will rescue or not, this will most obviously have the effect of raising the cost of funding for banks as a new tail-risk that was previously ignored has now become part of the pricing thought process.

This increase in cost for banks may reflect the reality of the risks that they face, and these new rules may be designed to reduce the amount of irresponsible risk taking the banks bring in, but unfortunately in reality they just act as a drag on the economy. This is because the increased cost of funding doesn't really force the bank to reduce risk - the key problem is that they borrow short and lend long - and the extra cost gets passed on to the individuals and companies in the real economy that needs credit to function and to invest and expand and create jobs. Regulators feel like they are punishing the banks, but the reality is that we

are now in a situation where pricing is just adjusting for the fact that funding costs have gone up. More regulation has increased rigidity for the real economy and is undoing the work of central banks in getting yields lower to make borrowing cheaper.

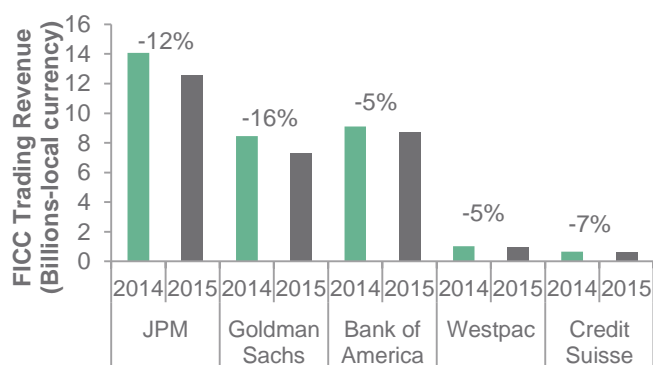
Chart 3: Quantity of capital is up...



Source: Bloomberg

This effect is now happening in the traded credit markets too. Revenue in the 'FICC' (Fixed Income, Currency and Commodity) departments of banks and brokers has been declining quite rapidly, along with headcount and market coverage. The chart below shows the fall in revenue across a number of key trading banks around the globe. While the revenue declines in the chart may not seem huge, these revenue numbers are against increased funding costs, and higher capital requirements. This has reduced return on equity to very low figures for once strongly earning sections of the bank, and with this has gone the huge compensation packages as well.

Chart 4: ...while revenues are down



Source: Respective company financial statements

We'll leave it to you to feel what you want to feel about the compensation of traders (we are guessing most won't mind that much) but what we are worried about is the effect that this has on market pricing and more importantly, liquidity. It was interesting to see the head of Deutsche Bank, John Cryan, make comments suggesting that bonuses would not make him work any harder or lesser. He went on to say, "I've never been able to understand the way additional excess riches drive people to behave differently." Perhaps those days are over, no matter if these businesses return or not, but we are sure a large part of these comments is him playing the politician.

Everybody has paid

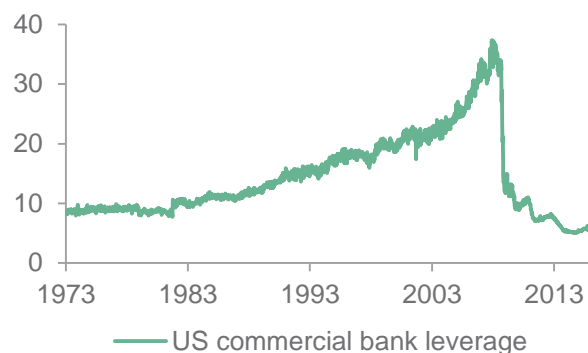
These increasing capital requirements are the other painful side of regulatory changes that are making banks far less profitable and are reducing the liquidity they can provide to the general market. The first changes have been to increase the amount of capital required in its total quantity and how much is needed for each transaction. The Telstra bond in the example before would need to be bought at a higher yield to compensate for the fact that the bank will have to hold more capital at the 'A' credit rating level as compared to before the changes to capital requirements took place. If a bank is deemed to be systemically important because of its size, the capital required is even higher. At historical credit spread levels, the bank just can't be in the business of providing liquidity profitably.

This situation is even worse for US banks who are now subject to a general leverage ratio. I wrote about my concern with this back in the November issue of this newsletter, where I took a deep dive into the liquidity issues of one of the safest markets in the world, the US Treasury market. These liquidity issues still exist there, and they definitely will have an effect on riskier markets like credit, but to a lesser degree as the purchase of Treasuries had very few regulatory restrictions previously.

So it is fairly clear that the regulators have gone to town on the banks to simultaneously punish them for the GFC and possibly try to stop it from happening again. We are doubtful though that they will succeed in this second aim and in fact are making the situation much worse. Taking a step back and looking at the big changes to regulation, would having this extra capital have saved Lehman Brothers? Probably not as the securities it owned were apparently 'AAA' and wouldn't have required much (or no) capital to be put against them anyhow. If it was funded by debt that was able to be bailed-in would that have saved it? Again, probably not even if would have meant that the bank could have been gone on as a going concern in its limping state. It would have avoided an immediate bankruptcy but remember that the US government may not have liked it but actually made a lot of money saving the rest of the banking system through TARP at the time. Centralised clearing would have made the effort of cleaning up after a bank failure like Lehman Brothers easier, but would have done little to avoid it in the first place.

The total leverage ratio however is one that would have definitely stopped the GFC from occurring altogether. As mentioned before, the total leverage ratio stops leveraging up the balance sheet too much with 'risk-free' assets. Leading into the GFC those 'risk-free' assets were crappy mortgages and CDOs that were just plainly rated incorrectly. Because of this error in judgement (and admittedly it was a huge error in judgement, and one that likely involved fraud as well), the rest of the economy will have to bear costs due to liquidity issues and a higher cost of doing business on most of traditional banking that banks have actually done a decent job on judging risk. The trade-off is clear as a tighter leash on the banks by telling them you can't say what is low risk or not means higher costs for credit in the economy. There is no 'punishment', only the price of credit adjustment.

Chart 5: Low leverage affects market liquidity



Source: Bloomberg

To add insult to injury it is not only the regulator who is dealing the blows to the profitability of the banking system. In some countries negative interest rates are making business more and more difficult to do as it is difficult to charge depositors negative rate, shrinking margins. And with the dearth of lending opportunities, any cash left on deposit with the central bank hurts. What are the banks to do? For the lending they are making, prices will have to increase to cover up the holes that have formed elsewhere. It is no wonder bank equity prices have tumbled with more than 20% of global government bonds on issue trading with a negative yield.

No major expansion in credit spreads - yet

With this knowledge it is interesting then to see that credit spreads really haven't moved that much from post-crisis levels until recently. With the exception of the Euro crisis in 2011-12 and the Taper Tantrum in 2013, the Australian iTraxx has traded in a very tight range of less than 50bp. This is wider than the ridiculous levels seen before the GFC, but has hardly deviated given the huge changes that we've seen in how banks do business. This is now shifting; however it is shrouded by the view that recent widening has been caused by problems with the mining and energy sectors. As always these shifts have a catalyst, and in this case it was falling commodity prices. Falling commodity prices have also pushed several central banks into negative rates in the first place, causing widening in bank credit

spreads and further damaging credit pricing, entering it into a negative spiral as climbing bank funding costs force the general credit market wider.

Chart 6: Back to crisis levels without a crisis



Source: Bloomberg

Are the recent moves hiding a more substantial move wider in credit than weakening energy companies and banks suggest? We think this is most definitely the case. The market is trying to find a new equilibrium where the traditional liquidity provider can make its way back to the market to maximise liquidity and price discovery. This process will take a while because new regulation is still being applied and the banking system is learning how they work and adjusting themselves to it. But as we've seen, these effects will bite soon enough. How much wider will credit have to go? This is unsure but the read is clear - just like US housing, European peripheral government bonds, Chinese equities, oil, copper and other commodities - previously held assumptions on credit may no longer apply. How much has a world awash with liquidity supplied by QE affected the adjustment of credit to a new wider plateau? This is a hard question to answer but the end of QE in the US and now rate hikes is now causing the tide to retreat leaving markets to finally stand on their own two feet. If you own credit, make sure you are protected through another asset class like bonds.

Large cap equities are a great example of how a liquid market moves prices quickly. Falling

liquidity should mean rising volatility as the market has to adjust quicker to sources of liquidity. The homogeneity of equities and their perpetual nature helps this as well, but the point still stands that even though this market is more volatile, at least liquidity can be sourced. We argue that the credit market has to achieve balance in the same way, and that means materially lower prices and wider credit spreads going forward.

This move wider in credit spreads has the potential to hurt many investors as many fixed income funds, both globally and domestically, tend to run a long credit, short duration book. These funds have seen a massive increase in their funds under management recently but recent returns have fallen short of expectations. Given the declining liquidity and increasing volatile markets we expect going forward, we think these recent trends will gain pace. There is a time and a place to be in illiquid, carry products and this is certainly not it.

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BT Investment Management's Income & Fixed Interest team of eight dedicated professionals, led by Vimal Gor, manage the #1 performing Australian composite bond fund of 2014 and 2011.

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