

An aerial photograph of a vibrant turquoise ocean. White, frothy waves are breaking over a dark, rocky reef structure. Several people are visible in the water, some near the waves and others further out. The water's color transitions from deep blue to lighter turquoise as it approaches the shore.

# Australian Quarterly Update

July 2018

PENDAL



# Rates outlook



Tim Hext  
Portfolio Manager

When we sat down at Pandal late last year to look at the themes we believed would drive global markets in 2018 two stood out. Firstly, with peak QE having passed, markets would have to deal with declining global liquidity. Secondly, with the Federal Reserve seemingly convinced of the need to get the Fed Funds rate back towards 3%, the resurrection of US cash as a viable asset class would crowd out many other asset classes that were crowded in since the rate hit near zero in late 2008. This has been called the end of TINA (There Is No Alternative to risk).

Two major tailwinds that were in place for almost a decade post the GFC were becoming headwinds. The key then was to pick which markets were sufficiently supported by strong global growth (which after all enables the resumption of normal monetary policy) to withstand these headwinds and which markets would be shown to be built on foundations more resembling sand than rock. These duelling forces would see the winners and losers emerge during the year. Our macro views and modelling has seen some success during 2018 in this strategy in our global funds.

However, for Australia the impact of these themes is less clear. After all we've had normal monetary policy right through this period. As discussed in our last newsletter the economy has rebalanced so is less exposed to variation in specific sectors. The falling offshore USD liquidity has seen higher money market rates in Australia (see the Cash Market section), but equities and credit spreads have been generally resilient. Higher Fed Fund rates have caused some weakness in the Australian dollar (our cash rates have finally become lower than US rates) but strong commodity prices has made the moves smaller than expected and the Trade Weighted Index has been relatively stable.

For Australia the duelling forces have not yet seen a winner. We remained this quarter stuck in the Macro Mire discussed in our last quarterly update. The RBA this week hit 21 months of no cash rate changes and markets predict they will easily head into the 30s. However, our job is to be vigilant as the economy evolves and as always look for early signals that perhaps the RBA can change the all too familiar words - "holding the stance of monetary policy unchanged at this meeting would be consistent with sustainable growth in the economy and achieving the inflation target over time."

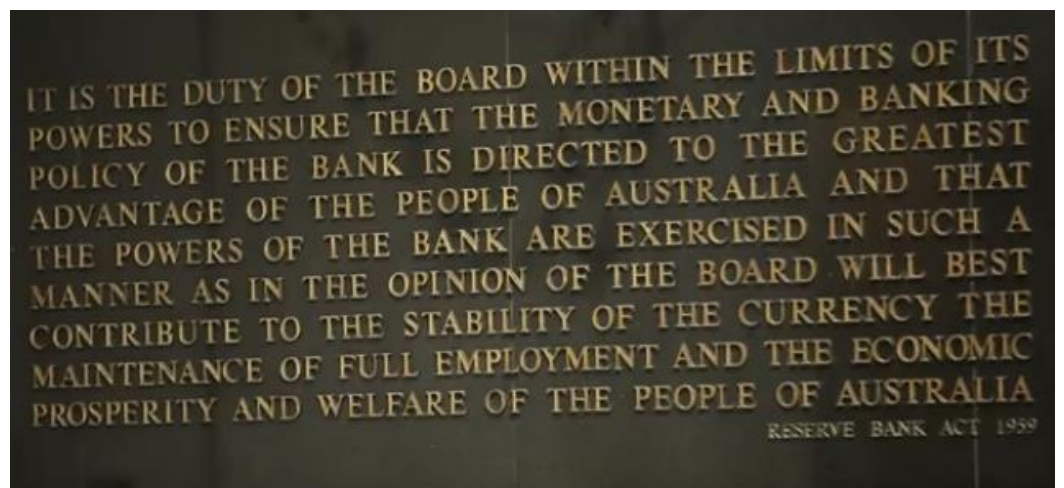
## RBA Governor in Portugal

Portugal holds many surprises for me. Watching a documentary recently called The Big Wave Project I was interested to see that one of the biggest rideable waves in the world is at Nazaré, on the Atlantic Coast of Portugal. How big? This photo gives you an idea.



That is not Phil Lowe riding the giant wave. Rather one of the many big wave surfers that travel to the small coastal town each winter in an attempt to tame the mountain of swell.

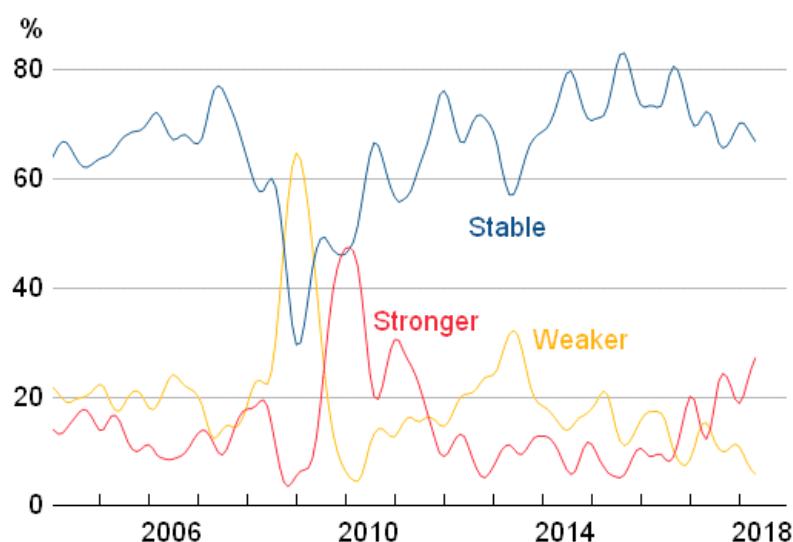
Phil Lowe, however, was down the Portugese coast in Sintra in June as a guest at the ECB Forum on Central Banking. As part of the conference Governor Lowe appeared on a panel with the three heavyweights of central banking, Federal Reserve Chairman Powell, ECB President Draghi and BOJ Governor Kuroda. Maybe coming from a smaller economy with less global focus on every word helped, but Dr Lowe gave a very frank and honest assessment of how he is running the RBA in Australia. He referred to his triple mandate, incorporating not only price stability and full employment but also the “economic prosperity and welfare of the people of Australia.” Just in case you doubted it, the words are inscribed in brass on marble in the foyer of the RBA building in Martin Place.



This stands in contrast to his fellow panellists, where the ECB and BOJ have only their inflation targets and the Fed have their dual inflation and employment targets.

Dr Lowe emphasised how the welfare of the Australian people influences his thinking on monetary policy. Given the persistence of lower than target inflation Dr Lowe suggested it was better to accept it than keep pushing on monetary policy to get it back up. This is given the financial stability implications of very loose monetary policy to cause rising debt and asset values. He also emphasised the role that the Governor can play in attempting to push up wage expectations from the recent norm of 2% to something with a 3% handle. Only a week before Sintra, Dr Lowe revealed in a speech that businesses on balance expect higher wage outcomes next year (see Chart 1). This cited one of the RBA's internal business liaison surveys, which are rarely publicised.

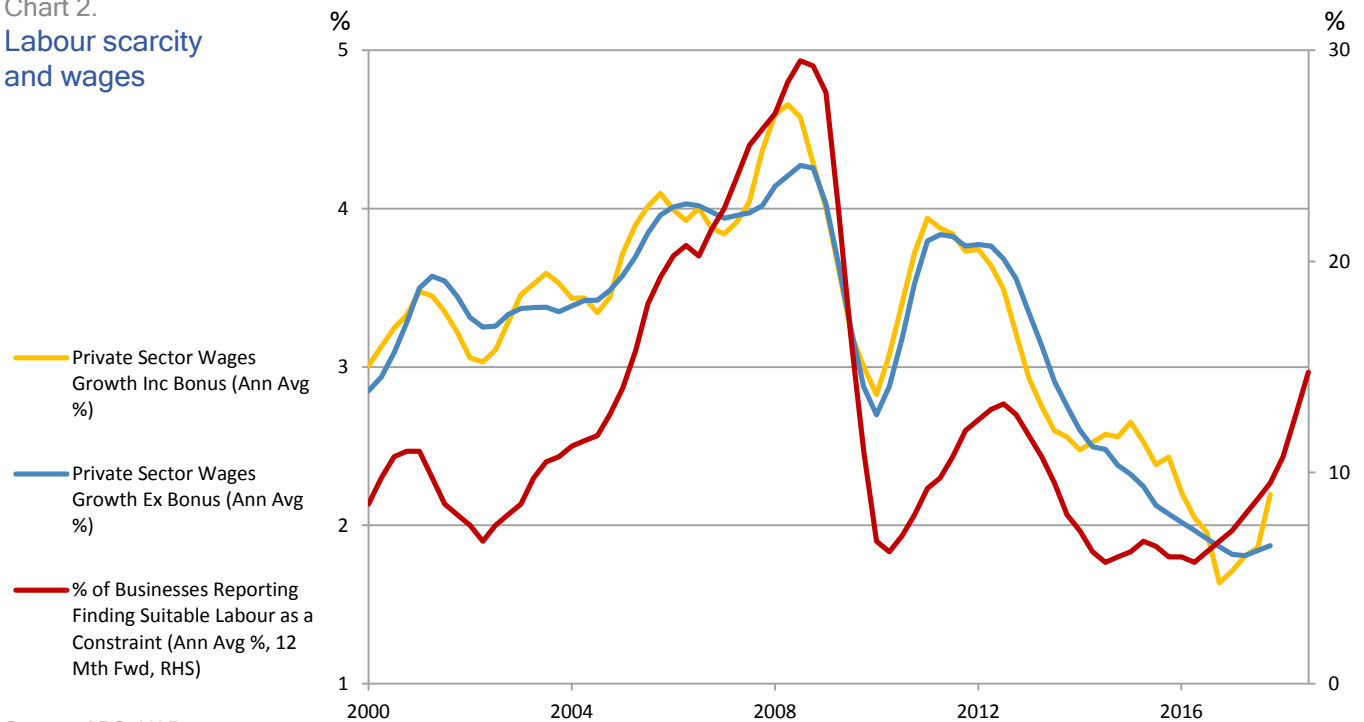
Chart 1.  
More businesses are  
expecting stronger  
wages



Source: RBA

Dr Lowe is now seemingly on a campaign to get wages higher, a plus for two of his three objectives, pushing up inflation and the welfare of the Australian people. The US experience shows that employers will do everything possible for as long as possible to avoid this as costs are the one thing they feel they can control in a world of rapid globalisation and technological change. Therefore as finding workers becomes tighter, which employers in Australia are suggesting is happening, they have a Plan B to implement. Firstly, get more hours out of existing workers and secondly increase bonuses (more flexible) rather than more permanent wage increases. Recent data shows that remuneration including wages and bonuses is tracking much closer to difficulty in finding labour than wages alone (see Chart 2). More workers are reaping the rewards of tighter labour markets than the wage data alone suggests. Together with the experience in other countries with sub 5% unemployment it suggests the RBA has reason to be confident that wage rises, though gradual, will push up towards 2.5% over the next year.

Chart 2.  
Labour scarcity  
and wages



Source: ABS, NAB

Three other recent developments will add to this confidence. Firstly, as of July 1 the 20% of workers on the minimum wage get a 3.5% increase. Secondly, state governments in Victoria and Queensland, as second term labour governments often do, have loosened the purse strings, with public sector wages increasing 2.9% in Victoria and 2.7% in Queensland in the last year (with accompanying large increases in numbers of public servants) and likely heading higher. Whether the Federal Government, of which Governor Lowe is a part of, change their 2% policy with the improving budget position remains to be seen, but it is perhaps where the central banker with his influence may choose to head first. Finally, average annual wage rises in new Enterprise Bargaining Agreements rose 2.7% in the March quarter, up from 2.2% six months ago. Construction was the stand out at 5.5%, with signs the massive infrastructure boom is finally kicking along wages.

With markets pricing out rate hikes there is always the possibility that the RBA lean the other way and start talking rate cuts. Candidates that could support such a change focus largely on the housing market. Although another rationale could be a need to offset rising mortgage rates due to increased funding costs. The fact is though, having heard Dr Lowe with all his passion at Sintra talk about financial stability and the welfare of the people, such a change would need significant weakness in housing spreading to significant weakness in consumption and employment for him to look at lower rates. We are currently a long way from both.

Therefore, domestically the case for higher rates builds, but very gradually. Global wobbles will likely see credit spreads drift wider and despite strength in the US economy in 2018, it will see global growth momentum track sideways, albeit at strong levels of around 4%. As our two major global themes of 2018 play out Australia will be largely a spectator, but sadly like an episode of Gogglebox we must watch the RBA watching the world.



# Cash markets



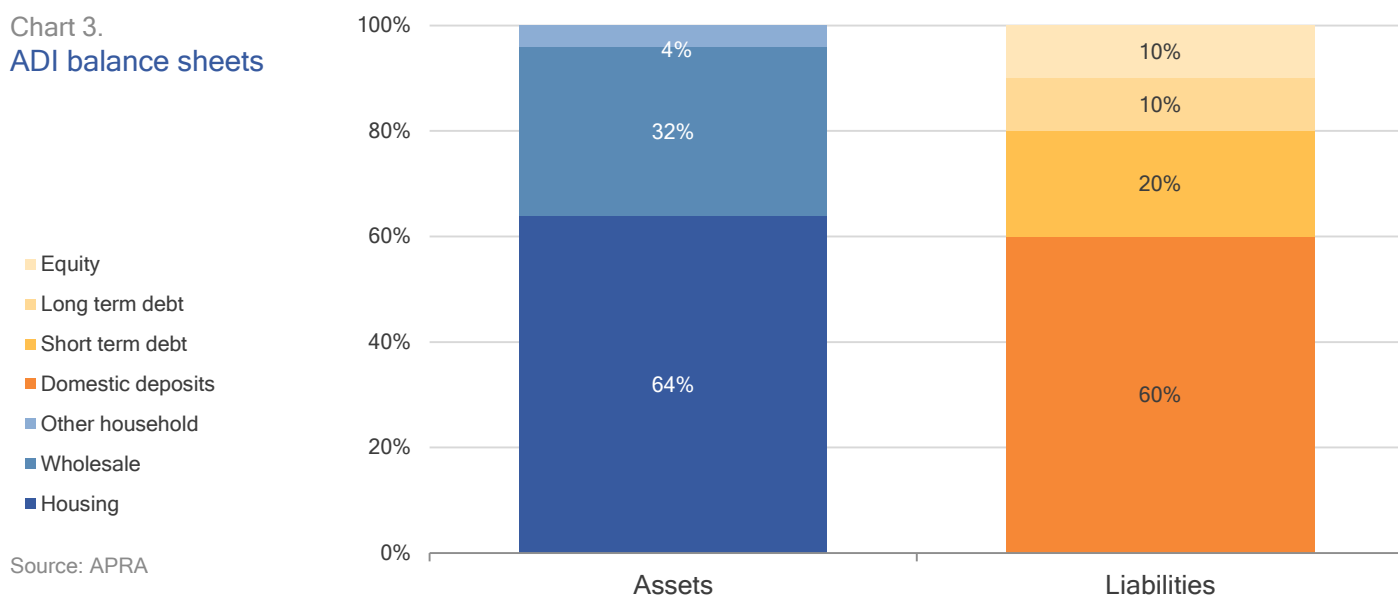
Steve Campbell  
Portfolio Manager

## Would the major banks hike and would the RBA care?

Recent pressure in wholesale funding markets has seen a building view that banks need to hike home loan rates to protect their Net Interest Margin (NIM). Is this justified and what does it mean for markets?

Domestic Authorised Depository Institutions (ADIs) have balance sheets that on average look like Chart 3 below.

Chart 3.  
ADI balance sheets



Source: APRA

Let's focus on the cost of bank's liabilities over the last year. At around 60% of liabilities domestic deposits are by far the most important. Term deposits rates have been flat to falling as competition to build up the deposit base and meet the Net Stable Funding Ratio (NSFR) has lightened. The average three month term deposit rate by the major banks has dropped from an average of 2% in late 2016 to 1.95% last year to 1.9% this year. Of course many current accounts pay no interest, meaning the overall cost of retail deposits has changed less. Therefore the good news for banks is that 60% of liabilities have become slightly cheaper in the last 12 months and have no direct link to wholesale cost of funds. The bad news for the banks is that 50% of their assets, the home loan book, is also not directly priced off BBSW.

However, wholesale liabilities, or 30% of total liabilities, are priced off BBSW (apart from some fixed rate issuance which is indirectly off BBSW anyway). With BBSW having risen by around 30bp in the last 6 months this has an impact on the overall cost of funds. Against though, the majority of commercial loans are also priced off BBSW so the impact of higher rates is partially offset.

Putting all this together the much talked about rising cost of funds for Australian banks is quite muted. In 2017 the RBA's estimate was that overall funding costs declined by 4bp. Banks were also able to increase their investment housing loan rates even though the new APRA 30% cap was only for new loans. Against this competition in the commercial market meant lower margins. On balance though banks saw a welcome increase in NIM as evidenced by Westpac moving from 2.07 to 2.16% in the recent half year results and NAB from 1.82% to 1.87%.

This year so far has seen widening term spreads and higher BBSW rates. Assuming wholesale cost of funds has increased by 30bp, on 30% of your liabilities this should mean a 10bp contraction in NIM, which would take it back to 2017 levels. However with a significant portion of commercial assets also pricing off BBSW the net result is likely closer to 5bp. In its recent half year results NAB estimated their NIM would decrease by 2-3bp if current funding conditions continued, a number likely closer to 5bp for the more domestically exposed CBA and Westpac.

Either way whilst banks would like to increase rates, and the narrative is that only the Royal Commission fallout is stopping them, the pressure at this stage is not significant and the RBA will not be considering this as a factor in setting its monetary policy.

As for what has been happening to BBSW, please refer to our July monthly newsletter which goes into more detail on some of the drivers behind the recent moves.



George Bishay  
Portfolio Manager

# Credit markets

We maintain our recently adopted neutral view on investment grade credit.

Credit markets have lost the Teflon coating they had during most of 2016 and all of 2017. For those two years, credit spreads were much more appealing, with the Australian iTraxx reaching a high of +173 in Feb 2016. The market's concern around a slowdown in China and a hawkish Federal Reserve had started to recede, we also had the European Central Bank buying corporate bonds. These factors drove down equity volatility with the VIX index falling from 28 to 9 by the end of 2017, this also saw credit spreads stage a strong rally with the Australian iTraxx closing out 2017 at +58.

However, 2018 has seen a reversal of these factors. We are starting to see signs of a slowdown in growth in China, the Fed is raising rates due to signs of US inflation, and the ECB is planning the tapering of its corporate bond buying program. Also, concerns around potential global trade wars and European politics are dragging down risk sentiment. This has seen equity volatility pick up and credit spreads widen with the Australian iTraxx closing out June at +80.5.

Chart 4.  
Credit spreads have  
reversed course in 2018



Source: Bloomberg

Reduced market liquidity, in part due to a withdrawal of central bank stimulus will see increased volatility in markets. All these factors leave us cautiously positioned until we get further clarity on these developments.

However, we do acknowledge strong corporate fundamentals remain with healthy balance sheets, positive earnings growth and low default rates for high yield.

On balance, the uncertainty and less attractive risk-return trade-off warrants a neutral stance for now. We believe investment grade securities should outperform high yield issuers in this environment.



# ESG



Edwina Matthew  
Head of  
Responsible Investments

## ESG case study: Coca Cola Amatil

For a number of years, Pandal has taken a decision to be underweight Coca Cola Amatil in our Australian fixed interest funds, given our ESG materiality concerns that were not reflected in its credit spreads.

Coca Cola Amatil is one of Asia-Pacific's largest bottlers and distributors of beverages and the majority of its products are high in sugar. Pandal has held concerns for many years regarding headwinds from structural shifts in consumer demand for healthier options. Given the social risks of diabetes and obesity, as well as regulatory risks relating to the potential of sugar taxes, we believed this would impact corporate profitability and its credit spreads.

As can be seen in Chart 5, Coca Cola's Amatil's credit spread underperformed against similar consumer sector peers from 2017 and into 2018. The underperformance occurred as both social trends changed and competition intensified. In April 2017, the company released a profit warning based on volume and price pressures for its high-sugar products amid dwindling demand. The investment case was further reinforced in March 2018 after the company's credit rating was downgraded from BBB+ to BBB by a credit rating agency (Fitch). The agency cited a continued deterioration in the business due to falling demand for carbonated soft drinks and increased competition in still beverages. Its credit spreads have continued to underperform since this latest downgrade.

Chart 5.  
Coca Cola Amatil  
underperformance



Source: Bloomberg

More recently, on Monday the 25th of June, Coca Cola Amatil committed to a 20% reduction of sugar content in its non-alcoholic beverages by the year 2025. The company said the reduction is part of a pledge to move with the trends of healthier lifestyle alternatives. Although this is an encouraging step, our investment thesis remains and credit spreads still do not suggest this is an attractive opportunity given the risks previously noted. As such, we remain underweight.

The events highlight the financial implications of failing to factor emerging socially-driven shifts in behaviour. These are unrelated to the price of a can of coke and more to do with the future price of health. Overall, this is a clear example of how social trends can impact corporate profitability and ultimately company actions.

*The complete version of this case study was first published in a report by the PRI - Principles for Responsible Investment entitled 'Shifting Perceptions: ESG credit risk and ratings' which explores the disconnects encountered when integrating non-financial risk assessments. Read the complete case study at <https://www.pendalgroup.com/education-and-resources/investing-responsibly-a-case-study-on-assessing-credit-risk/> or visit <https://www.unpri.org/credit-ratings/> to download a copy of the PRI report.*

For more information call us on 1800 813 886  
or visit [pendalgroup.com](http://pendalgroup.com)

**PENDAL**

The information in this brochure is current as at 11 July 2018 and has been prepared by Pendal Institutional Limited ABN 17 126 390 627, AFSL No 316455 (PIL, Pendal). It is not to be published, or otherwise made available to any person other than the party to whom it is provided. Prior to May 2018, Pendal Institutional Limited was known as BT Investment Management (Institutional) Limited. This brochure is for general information purposes only, should not be considered as a comprehensive statement on any matter and should not be relied upon as such. It has been prepared without taking into account any recipient's personal objectives, financial situation or needs. Because of this, recipients should, before acting on this information, consider its appropriateness having regard to their individual objectives, financial situation and needs. This information is not to be regarded as a securities recommendation.

The information in this brochure contains material provided by third parties, is given in good faith and has been derived from sources believed to be accurate as at its issue date. While such material is published with necessary permission, and while all reasonable care has been taken to ensure that the information in this brochure is complete and correct, to the maximum extent permitted by law neither PIL nor any company in the Pendal group accepts any responsibility or liability for the accuracy or completeness of this information.

Performance figures are calculated in accordance with the Financial Services Council (FSC) standards. Performance data (post-fee) assumes reinvestment of distributions and is calculated using exit prices, net of management costs. Performance data (pre-fee) is calculated by adding back management costs to the post-fee performance. Past performance is not a reliable indicator of future performance.