

Income & Fixed Interest

Newsletter



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In last month's newsletter, I wrote about the pain points in global markets that were being revealed as a result of the roll-back in extraordinary central bank liquidity. Another pain point related to this is the availability of market liquidity. Since the GFC, market liquidity has changed structurally and for the worse. It has not been obvious in recent years because that liquidity, especially for exiting risk, has not been in demand. After all, what with global central banks pushing so much excess liquidity into markets in the last two years, any investor who has turned a blind eye to growing fundamental risks has been well rewarded.

This unhealthy Pavlovian response to rising risks is now correcting itself as the trend in global liquidity reverses. Investors' tolerance for risk ought to fall if the rewards for taking such risks have shrunk, but risk appetites are still correcting to the diminished risk premia. As Australia's past and present experience demonstrates, the smaller the market and the greater its reliance on global risk appetite, the more likely it will suffer from thinning liquidity. This month, I take a closer look at Australian cash and funding markets, how they have been impacted by the ongoing changes to global liquidity, and what that means for the opportunity set available to domestic investors.

The Reserve Bank has left the cash rate unchanged since August 2016 and with no imminent change to monetary policy on the horizon, investors could be forgiven for thinking that little volatility has been occurring in the Australian money market. But despite the Reserve Bank's inaction, volatility in the short end has picked up significantly in the first half of the year. One of the key spreads that we look at is the margin between the 3 month bank bill and overnight index swap (OIS) rate, which ended the month at the widest spread since the GFC. Typically, changes in this spread are driven by offshore movements such as the widening of Libor-OIS in the US market earlier this year. In June, this relationship became completely disconnected and exposed the frailty of the Australian funding markets. There is no single event which can explain this dislocation, but rather it is likely due to the accumulation of numerous changes over a period of time. A history lesson on funding markets, particularly short-end funding, certainly is not going to be a bestselling book anytime soon however some history is necessary to understand how we have arrived at the point at which we currently find ourselves.

Regulating for stability

Whilst Australia managed to largely escape the GFC, the experience of global financial systems during the crisis brought about a number of regulatory changes which have also applied to the Australian banking system. The combined effect of regulatory changes has resulted in poor risk appetites and a lower willingness to provide market liquidity from our major banks.

Prior to the GFC banks were more reliant on short tenor and highly liquid sources of funding as a way to finance their assets which ultimately led to a significant mismatch between the assets and liabilities of financial institutions and significant flight risk. Whilst it might be cheaper for banks to fund via short term debt, the shorter tenor also means that funding can vanish very quickly at the point when it is most needed. The Basel Committee on Banking Supervision (BCBS) addressed these risks eventually with the introduction of the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). These ratios came into effect from January 2016 and January 2018 in Australia and are covered by the prudential standard APS 210 -please bear with me, it does get more interesting.

The objective of the LCR is to ensure that Authorised Deposit-Taking Institution's (ADI's) have sufficient high quality liquid assets such as Commonwealth Government Bonds to meet its liquidity needs for 30 calendar days under a severe stress scenario. The objective of the Net Stable Funding Ratio's (NSFR) is to promote longer-term resilience of a bank's liquidity risk profile through banks funding their activities with more stable sources of funding.

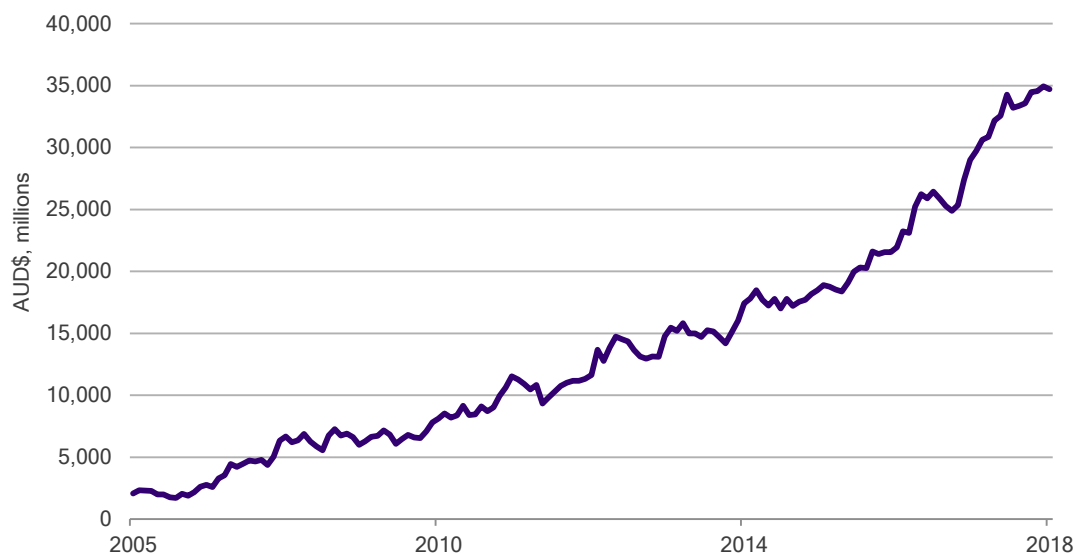
Short dated issuance (sub 6 month tenors) to financial corporations isn't deemed to be stable - understandable given that we would not hesitate to sell out of any exposure should we become concerned over the credit risk of the issuer. Retail deposits, regardless of their tenor, are deemed to be considerably more 'sticky' by the regulator and consequently provide significant value for banks when it comes to their stable funding calculations. It doesn't hurt banks that rely more on retail deposit funding to also point out that any deposit under \$250,000 is also guaranteed by the Australian Government.

Why Aussie banks prefer lending to households than corporates

Banks have also been required to hold more capital, which has the effect of lowering the return on equity (ROE). The RBA June 2017 Bulletin provides more detail how Australian banks have responded to tighter capital and liquidity requirements. The main points out of the bulletin is that the Australian Banks have responded to the higher capital requirements by adjusting their lending activities towards housing lending, which has a lower average risk weight. According to the Bulletin housing stock accounted for around two-thirds of banks' domestic credit, up from just above 50% in 2008. This may also be why we have seen an increase in corporate lending from non-Australian banks to Australian corporates. For non-Australian banks, the returns available from corporate lending are still generally higher than what can be achieved in other markets. In turn there has been a notable increase in the certificates of deposit issued by those banks in the Australian market.

The following graph shows the increase in certificates of deposit issuance issued by Japanese, Chinese and Singaporean Banks.

Chart 1.
New players in the market



Source: APRA

Aussie banks need to borrow offshore

This comes at a time when the funding composition of the Australian banks has changed, highlighted by the following graph presented by the Reserve Bank Assistant Governor Dr Christopher Kent in June.

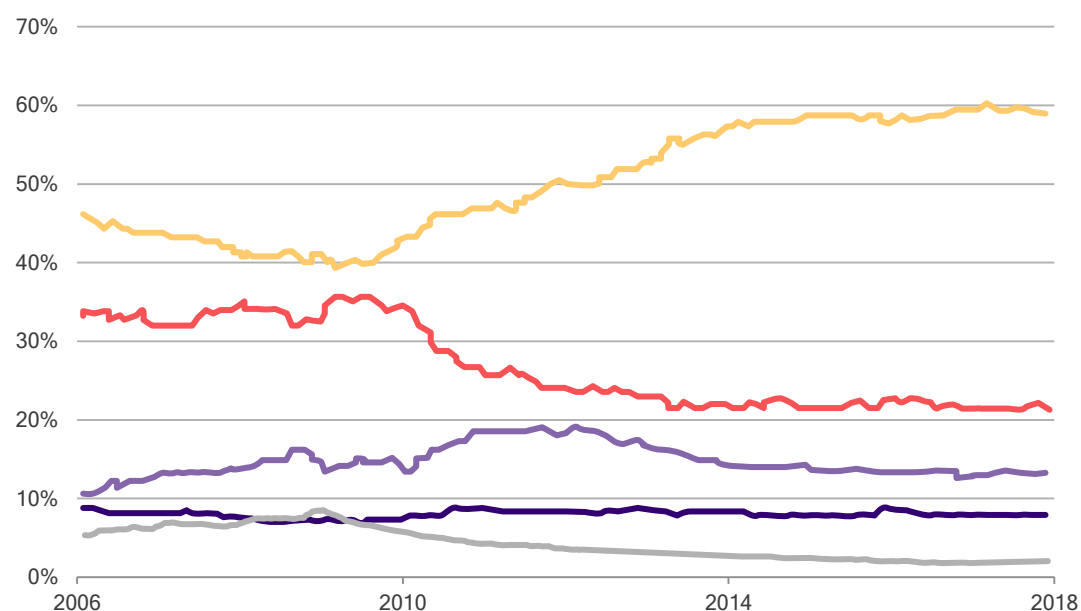
Chart 2.
A shift away from domestic short term debt

- Domestic deposits
- Short-term debt**
- Long-term debt
- Equity
- Securitisation

*Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

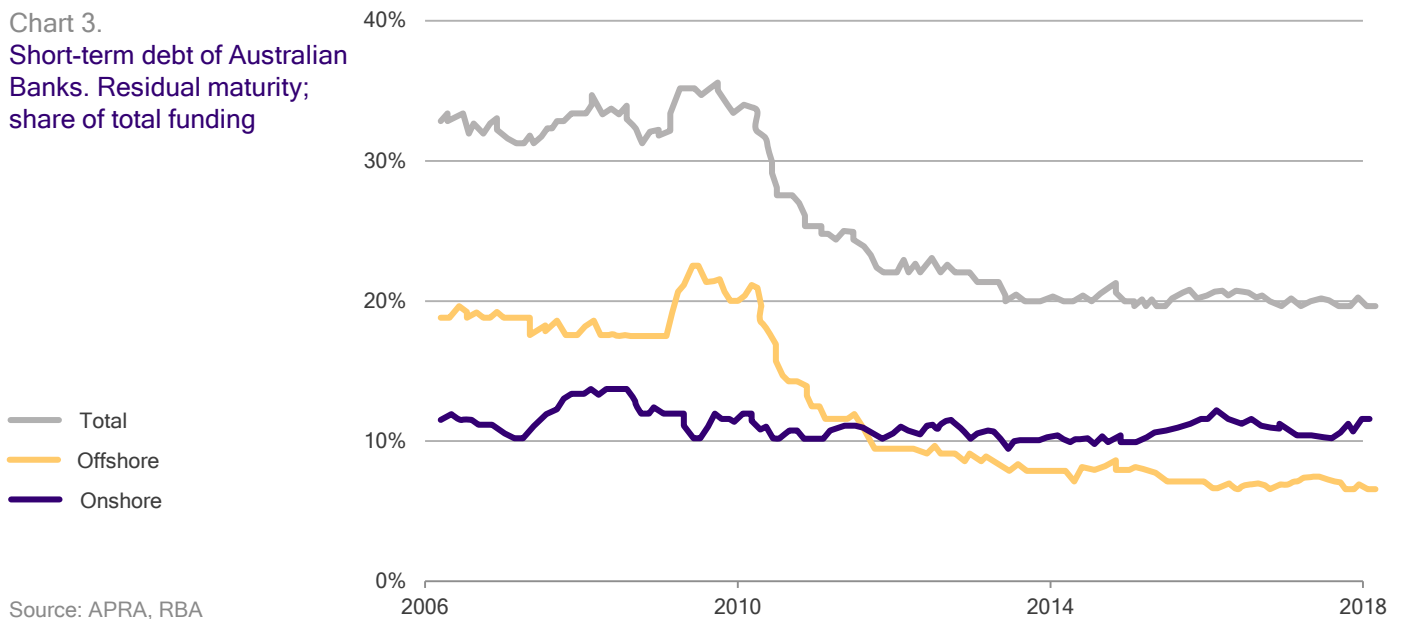
** includes deposits and intragroup funding from non-residents

Source: APRA, RBA, Standard & Poor's



We can see from chart 2 above that short term debt pre-GFC made around 35% of bank funding and has stabilised at around 20% since 2012, with the majority of this fall due to a decline in domestic issuance. The offshore market has remained a stable source of funding for the banks and represents the bulk of their short term funding.

Chart 3.
Short-term debt of Australian
Banks. Residual maturity;
share of total funding



Offshore short term debt funding for Australian financial institutions is predominately raised in the United States, which has a significant investor base between money market funds and corporate treasurers looking to park cash. There have been numerous recent developments in the US short end that has affected the demand dynamics and the price that issuers have had to pay to raise cash including:

- Changes to prime money market fund rules
- Increase in the supply of US Treasury bills
- Base erosion and anti-avoidance tax (BEAT)
- Repatriation tax

These developments were mainly negative for issuers of commercial paper in the US market and it is easy to identify their timing by looking at the Libor-OIS spread in the US market.

Chart 4.
Funding roller-coaster



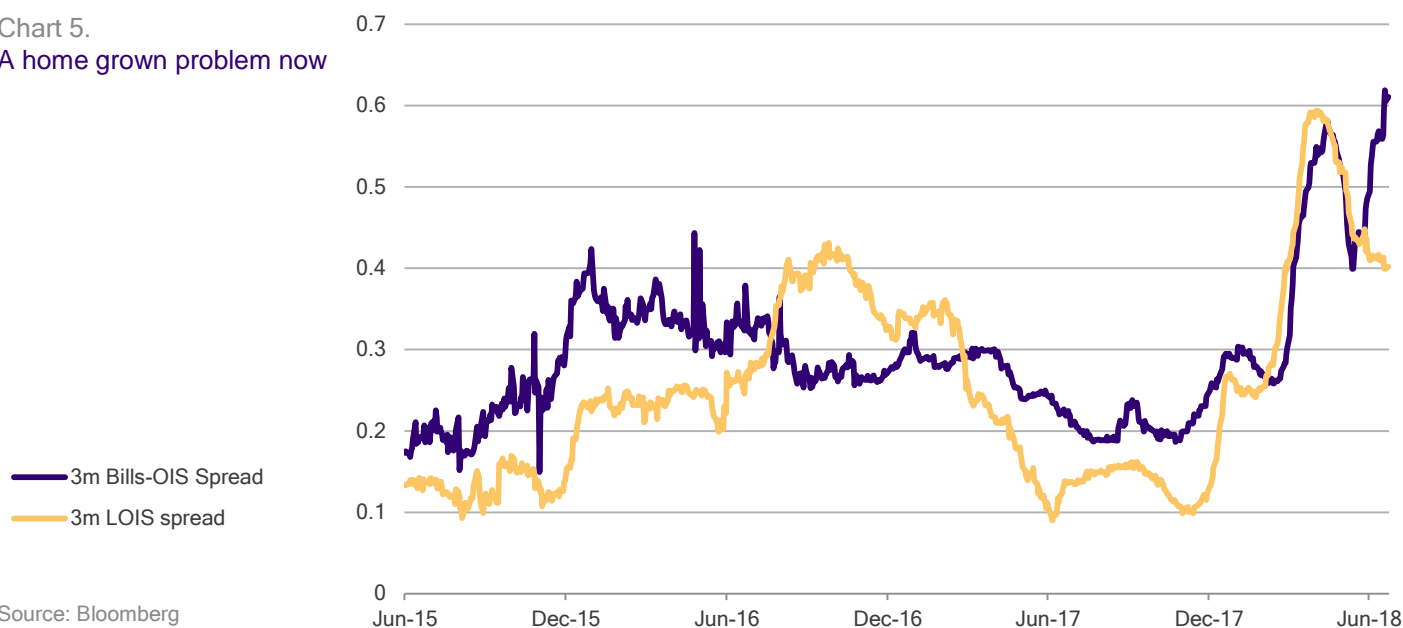
How US Libor-OIS spread affects Aussie banks

The changes in the prime money market funds came into effect in late 2016, although changes were flagged before this that saw flows out of prime money market funds. Issuers were required to pay a higher yield to attract funding given diminishing demand.

The large increase in US treasury bill issuance in early 2018 had the effect of 'crowding out' non-government issuers in the US market, and saw the Libor-OIS spread widen sharply in March. Simultaneously, changes in US tax rules brought about by fiscal reform resulted in more issuance by non-US banks into the US funding market. Lastly, the tax relief offered on repatriation of US cash held offshore by US corporates had the potential to affect demand, although this depends on where the assets were domiciled (likely to be predominately USD denominated so limited effect), whether cash was going to be deployed (dividends, share buybacks, CAPEX etc) and the tenor of the assets. Libor rates could have been supported if longer dated debt securities such as floating rate notes were liquidated and switched into short dated securities such as commercial paper. We did witness some selling of 1-2 year floating rate notes around this period which indicates that some corporate treasurers may have done this.

As for the impact of US Libor-OIS on Australian markets, the chart below shows changes in both markets.

Chart 5.
A home grown problem now



Source: Bloomberg

We can see that pre June 2018 that the correlation between the Libor-OIS spread and the BBSW-OIS spread had been strong. This is not surprising as there is likely to be substitution towards domestic market issuance should the US become too expensive to issue in. Ultimately the increase in domestic supply comes with a higher price for Australian banks, being higher yields.

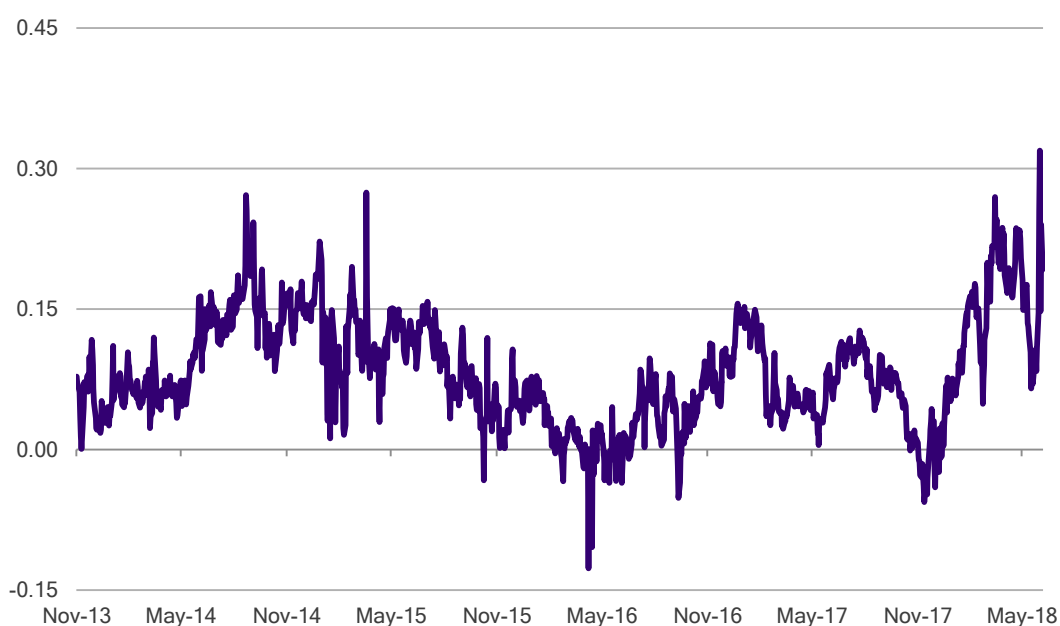
It's all about the basis, 'bout that basis

Chart 5 shows how it's all gone a bit ooohh-arrrrrr over the last few weeks, with a massive divergence opening up in June, while Libor-OIS actually contracted during the month.

At first glance, this divergence should highlight the relative attractiveness for Australian banks to return to the US markets for their short-term funding needs. However, raising cash in the US at a more attractive rate is one thing; the price that that translates back to when converted to Australian dollars and currency hedged is another. Chart X shows the difference between the implied 3 month yield from FX forwards between the Australian dollar and US dollar and the actual 3 month BBSW rate.

According to the interest rate parity theorem the difference between the implied and actual should be zero - the difference between the implied rate and the actual rate is what is referred to as the 'cross-currency basis'. This basis (difference) arises because of an imbalance in the demand for and supply of funding in the different currency markets. The higher the basis the more expensive offshore issuance becomes to swap back into Australian dollars for the issuer.

Chart 6.
Liquidity is not what it was



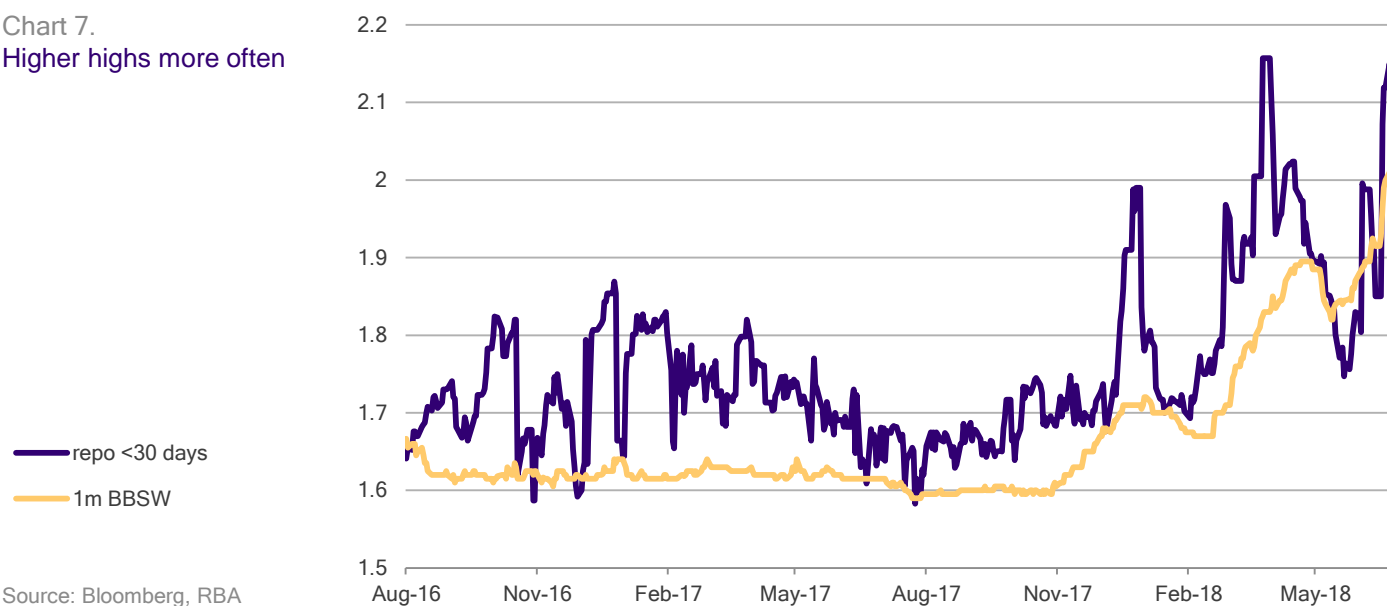
Source: Bloomberg

When the basis is in positive territory, which is most of the time, it is more cost-effective for Australian issuers to borrow domestically than in the US market, but the diversification benefits and the ability to access much deeper funding markets abroad usually far outweigh this slight cost advantage for Australian banks. Nevertheless, with the surge in cross-currency basis so far this year, cheap short-term funding is now harder to come by for Australian issuers.

Other sources of short-term funding for Australian issuers

As the offshore market has become less attractive as a source of raising funds, liquidity in domestic markets has also become thin. An alternate short-term source of domestic funding lies in the use of repurchase agreements, or 'repos', but repo rates have also exhibited funding pressure. For those unfamiliar with them, a 'repo' is a secured form of lending that provides the lender with cash for an agreed period at which point the security or securities are bought back at an agreed price. Typical securities lent under repo are Commonwealth Government bonds (i.e. high quality assets). Chart X shows the rate that repos with a tenor of less than 30 days have traded alongside 1 month BBSW since the Reserve Bank last eased monetary policy.

Chart 7.
Higher highs more often



Source: Bloomberg, RBA

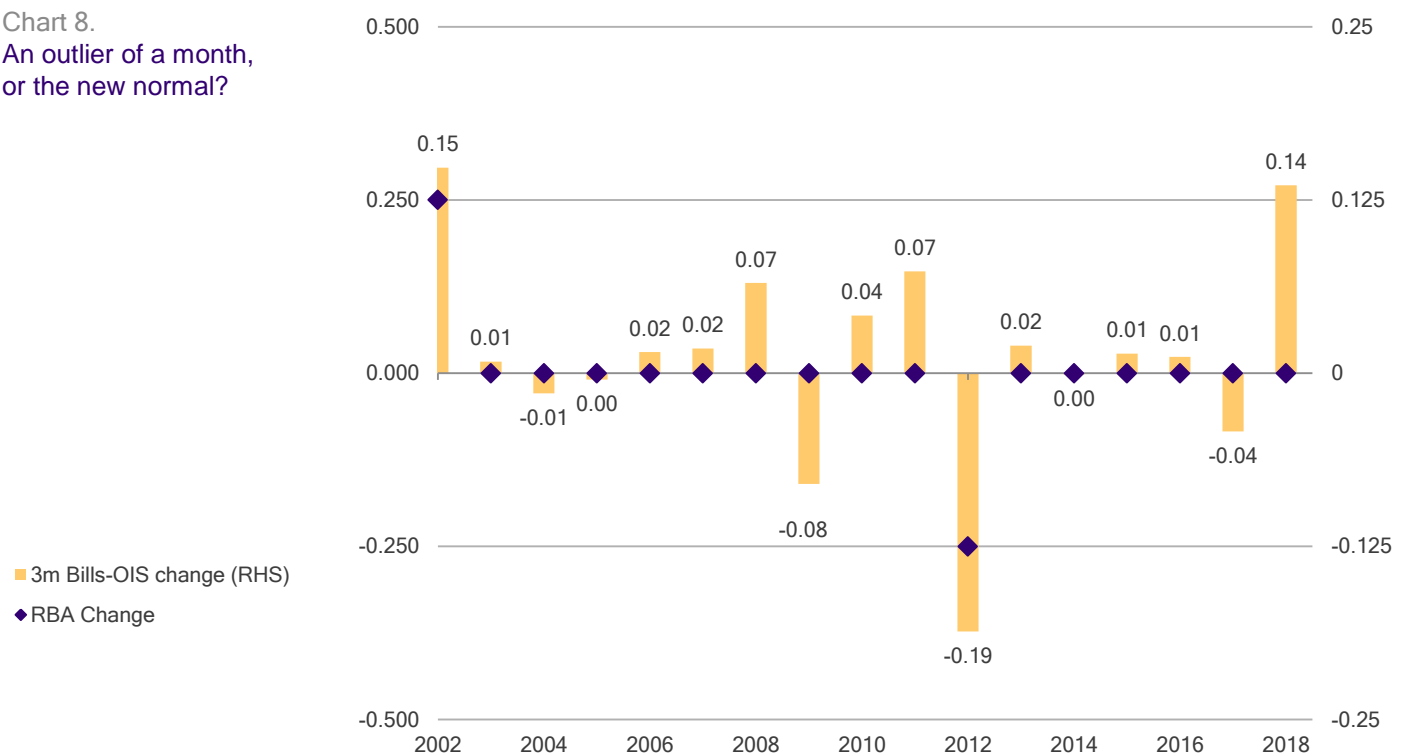
Whilst there might be some seasonally driven quarter-end tightness in funding, the volatility that has been witnessed since the December 2017 quarter end has been far in excess of prior spikes seen in the repo rate.

So liquidity is not what it was - be it in the forwards market, the cash market, or the secondary credit market. Regulation may also have played a part here. Bank treasury desks are more constrained now than what they previously were and are less likely to step in to support assets when price action becomes extreme.

Structural, not seasonal

Some commentators have ascribed the recent volatility and shrinking liquidity in Australian markets to seasonal factors as we moved into financial year end. The following chart shows the 3 month BBSW-OIS spread for the month of June since 2002.

Chart 8.
An outlier of a month,
or the new normal?



Source: Bloomberg

The largest move in 2002 coincided with the Reserve Bank tightening monetary policy during the month. In the five years from 2013 the spread has been largely unaffected as we move into financial year end. I don't subscribe to the extreme moves witnessed during the month as being purely seasonally driven - it may have had an effect but I expect the BBSW-OIS spread to remain elevated during July. We will get another look at seasonal dynamics in late September when 3 of the 4 major banks come into their financial year end (CBA has a 30 June year-end).

We do believe that there has been a structural shift in the market that will result in BBSW rates remaining elevated despite the Reserve Bank likely to leave monetary policy on hold in the nearer term. This has been driven by regulatory change that has seen funding composition changes, lending composition changes and new competitive forces. Regulatory change has also affected market liquidity with a reduction in market participants that will mean that periods of funding stress will become more common than what we have become accustomed to.

In addition, an extra 6 basis point tax imposed by the government on major banks' borrowing rates does little to incentivise larger issuance volumes from Australian banks. The extra 6 basis points of tax also apply to certificates of deposit, so if you're Macquarie bank, why issue beyond what you need and pay the tax man more? The lesser willingness of Australian banks to borrow in the market translates directly to their lower willingness to provide secondary liquidity to markets, from forwards to cash to credit.

Banks have to eat their rising funding costs

With the recent increase in funding costs the focus has moved on to whether the major banks would increase their home loan rates to protect their Net Interest Margin (NIM) and whether the Reserve Bank would ease monetary policy in response. We don't believe there is enough cause for any policy action from the Reserve Bank.

Let's focus on the cost of bank's liabilities over the last year. We can see from the earlier Funding Composition graph that around 60% of banks liabilities are made up by domestic deposits and 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 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.

Banks wholesale liabilities, which account for around 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 this though, the majority of their 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 4 basis points. 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 banks have seen 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's trend however has been 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 contraction of less than 10bp 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. This estimate would be consistent with NAB's recent half year results in which they indicated potential NIM compression by 2-3bp if current funding conditions continued and a number likely closer to 5bp for the more domestically exposed CBA and Westpac.

Either way whilst major 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 as significant as headlines would imply and the RBA will not be considering this as a factor in setting its monetary policy.

The central bank put

In prior newsletters, we've discussed at length that the normalisation path being pursued by global central banks goes beyond simply a desire to raise interest rates. While some scepticism may be warranted about a need to create policy room for the next downturn, at the heart of the normalisation is the aim to restore the original role of the central bank. As lender of last resort, the Reserve Bank is unlikely to engage in a monetary policy response to current developments in Australian markets, unless there are signs that broader systemic risk is rising as a result of worsening market liquidity. The role of the reserve bank is not to prevent costs of funds from rising as a result of demand and supply conditions changing, but to provide a backstop of liquidity to the financial system should be become at risk of seizing up altogether. In short, the central bank puts are being rolled down to much lower strikes globally.

Despite some of the recent pressure on lending rates translating through to higher mortgage rates, the longer term trend has been for mortgage rates to decline and recent moves need to be kept in context. Certainly a recent rise in some mortgage rates will not be enough to change the Reserve Bank's view on monetary policy, nor will a cooling housing market.

Aussie growth the envy of many

As for the longer term direction for the cash rate, the Reserve Bank's economic forecasts are the best place to start. Their most recent forecasts from the Statement on Monetary Policy (SoMP) released in May are as follows: -

	Year-ended					
	Dec 2017	Jun 2018	Dec 2018	Jun 2019	Dec 2019	Jun 2020
GDP growth	2½	2¾	3¼	3½	3¼	3
Unemployment rate ^(b)	5.5	5¼	5¼	5¼	5¼	5¼
CPI inflation	1.9	2	2¼	2¼	2¼	2¼
Underlying inflation	1¾	1¾	1¾	2	2	2¼

	Year-average					
	2017	2017/18	2018	2018/19	2019	2019/20
GDP growth	2¼	2¾	3	3¼	3¼	3¼

Source: RBA

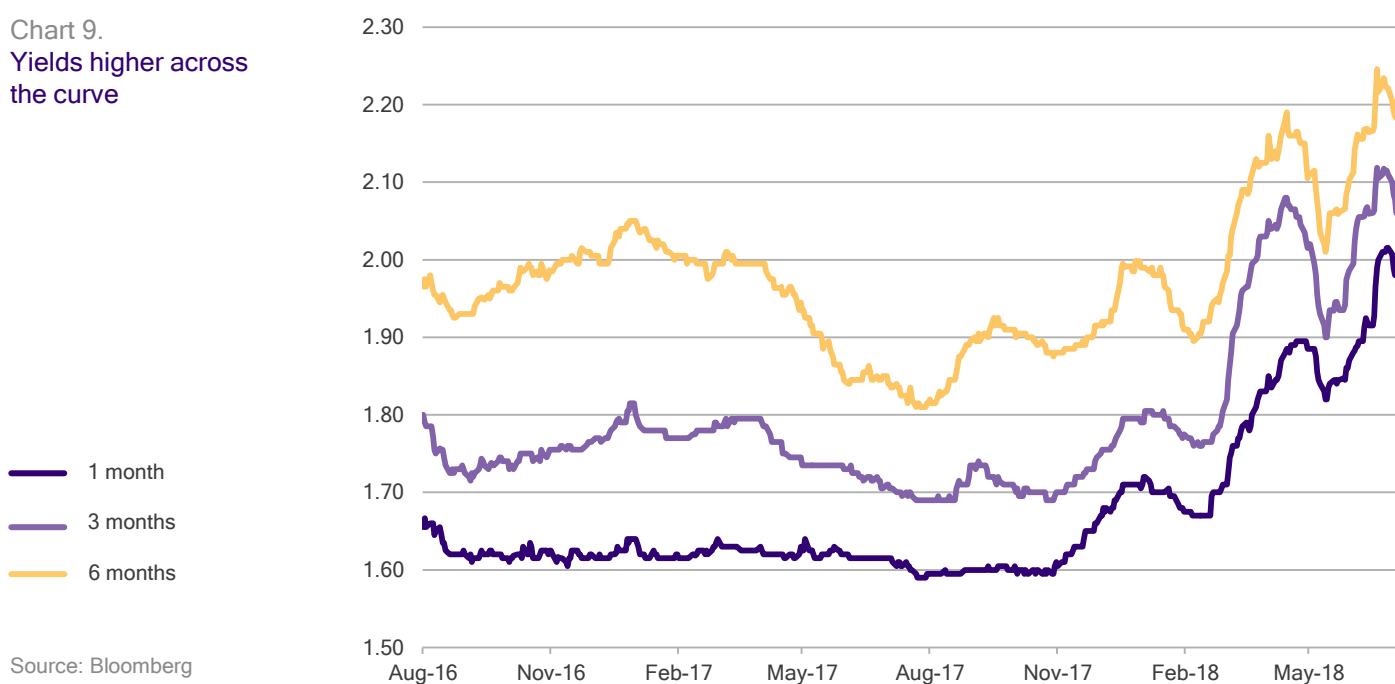
Underlying inflation is expected remain contained over the next 2 years, remaining below the lower end of their 2-3% target threshold for the rest of 2018 before increasing gradually from that point on. The Reserve Bank also look as though they are expecting slack to remain in the labour market with the unemployment rate forecast to be at 5.25% in 2 years' time. At that rate it is difficult to see wage inflation pressures getting out of hand. With these forecasts it is not difficult to make the case that the Reserve Bank will remain on hold for an extended period. Our growth rate is something that most developed countries would envy however. This will be supported by LNG production coming on line.

As for the next Reserve Bank move, there could be a risk that we are currently underestimating when that will occur. The market currently assigns around a 50% probability of a rate hike in the next 12 months. One high inflation number and that changes very quickly. Whereas a surprise inflation print to the downside would need to miss the Reserve Bank's forecasts significantly to illicit a policy easing response. Such a response would more likely be triggered from a deteriorating external environment than by domestic inflation trends.

Cash is king

If we assume that the Reserve Bank is on hold for a while, it need not mean a dearth of opportunities for Australian investors. As we have mentioned, we see the recent moves in Australian front end rates as being more structural and expect BBSW to remain elevated. So returns for investors will rise due to higher BBSW rates even though the Reserve Bank is on hold. The following chart shows how yields have changed on various points of the curve since the Reserve Bank last eased monetary policy to 1.50% at the August 2016 meeting.

Chart 9.
Yields higher across
the curve



Source: Bloomberg

Two things stand out: there has been a significant sell-off in yields in the first half of 2018, and yields of different tenors have converged in the course of this move (that is, the yield curve has flattened).

As mentioned above, the rise in 1 month BBSW has been beneficial for any holder of RMBS or ABS as they are usually reset off 1 month BBSW, but we have some concerns on RMBS. Even though a cooling housing market may not be sufficient to trigger an easing response from the Reserve Bank, it may have some impact on Residential Mortgage Backed Securities (RMBS).

Auction clearance rates are falling sharply, which in turn can affect the prepayment speeds for RMBS and see the Weighted Average Life (WAL) extend. RMBS holders may have experienced benefit from higher 1 month BBSW resets so far this year, but if the WAL of their securities extend and the traded margin (or credit spread) widens then the capital value of these securities will be negatively affected.

We remain concerned not only about RMBS but also about credit markets more broadly. If investors are also concerned about the state of credit markets then the thing to note is that the rise in BBSW means that you can reduce the credit spread duration (that is, shorten the tenor of the asset) of your cash portfolio without giving up too much absolute performance relative to where BBSW was late last year. With the headwinds for the credit markets starting to blow stronger the rise in BBSW gives investors an opportunity to reduce risk without potentially forgoing return.

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