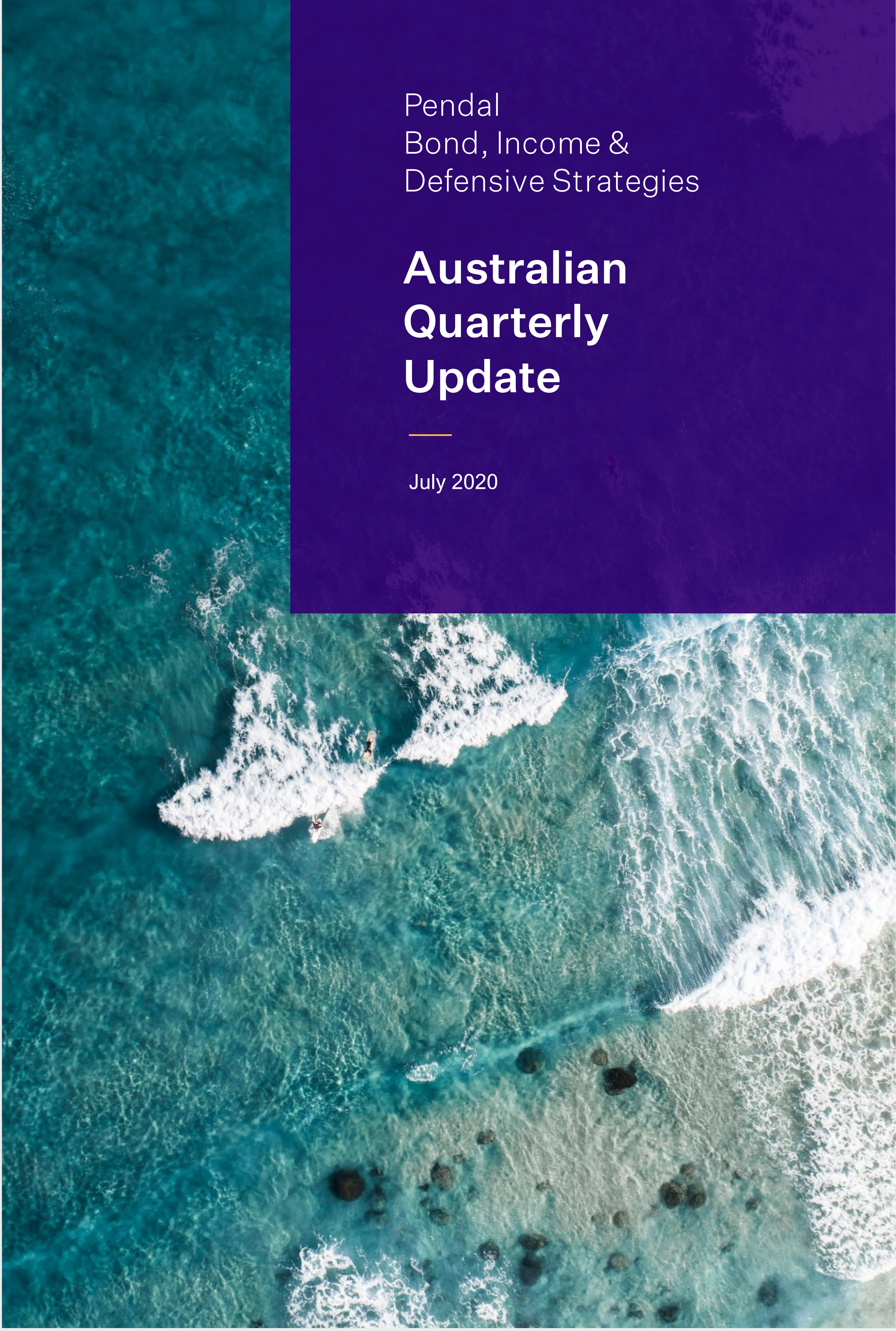


Pendal
Bond, Income &
Defensive Strategies

Australian Quarterly Update

July 2020

Rates

Avoiding a double-dip recession

Tim Hext
Portfolio Manager

My first year in markets was 1989 and my first trade was buying some bank bills at 18.5%. I should have bought a 30-year bond!

Crushing inflation had become a cruel venture, bringing on the recession that Paul Keating said we "had to have".

Living in Melbourne in 1990 was to witness first-hand an imploding economy. Businesses closing almost every day. Unemployment soaring. House prices collapsing. People struggling. Any job was a good job -- forget whether it was inspiring.

Recessions were seen as a natural part of the business cycle.

In the early 1990s even the most optimistic economist would have expected another recession within 10 years. The odds of a 30-year wait would have been longer than Parramatta or Carlton going without a premiership for decades. The true miracle was avoiding a recession during the GFC. China rode to the rescue and the real economy avoided the fate of financial markets.

Walking around a number of shopping centres and strips in the past month brought back memories from Melbourne in 1990. "For Lease" signs everywhere and shops boarded up. I stopped to look in the windows of closed businesses. Some signs said "Opening Soon When Safe" – but sadly many have closed for good.

Large numbers of retail stores were marginal before the crisis. Rent relief beyond 50% was at the behest of landlords. Some landlords have worked to keep tenants but others have merely added the other 50% to future bills.

Perhaps the crisis has merely accelerated the push to clicks over bricks – and retail will bounce back. If enough workers are still getting paid they will spend it online. Restaurants may survive via delivery. The fleets of electric bikes around my neighbourhood have swollen.

Last quarter I spoke about the shape of the recovery as the economy cautiously began to open up.

Adding to the list of V, L, U and W we now have the Reverse Square Root, the Nike Swoosh and other shapes showing the speed of the recovery.

This quarter I will look at the progress so far and ask the question: when will we get back to where we were in February? We did not know it at the time, but the high-water mark fell in between the bushfires and COVID.

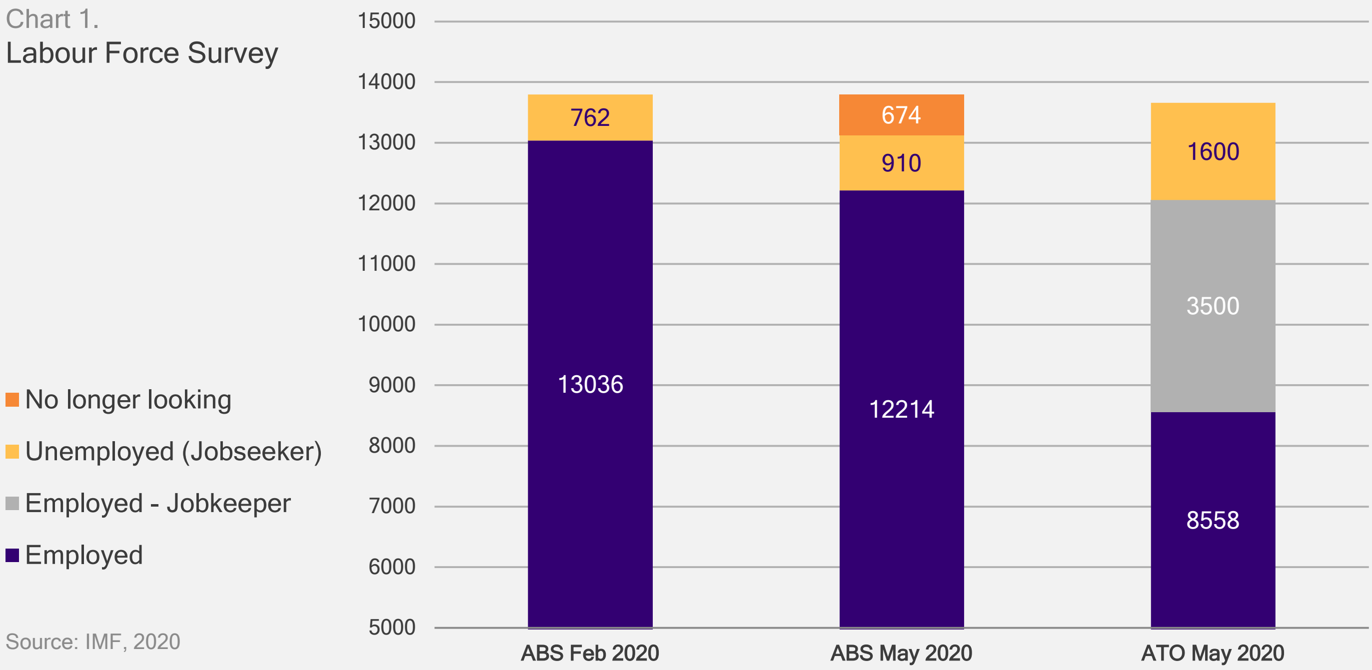
Employment and population

In February 13,056,700 Australians were employed. This was an all-time high. Australia's population was 25.5 million. The population increased by 350,000 in the prior year including 210,000 being migrants. A record 66% of Australians over 15 years of age were either working or looking for work, meaning an unemployment rate of 5.1%.

Flash forward to May 30 and 7.5% of jobs had been lost according to tax office data. This equated to 980,000 jobs. At the worst point in April it was 9% or 1.18 million. These are jobs where people are not getting paid. How many will return with the re-opening of the economy and how many have disappeared permanently? That remains to be seen.

Graph 2 shows the different measures of employment. Since March the Bureau of Statistics has released tax office data in a weekly payrolls report. This data is electronic rather than survey-based like the official labour force numbers. This is a far more accurate measure. It captures the large cohort of workers laid off but waiting for businesses to reopen so they can hopefully get their jobs back.

Chart 1.
Labour Force Survey



Source: IMF, 2020

On March 20 Newstart was renamed JobSeeker and increased from $550 to $1100 a fortnight. About 1.6 million Australians are now on JobSeeker, up from 700,000 on Newstart in February. The labour force survey shows 835,000 jobs lost from February to May.

Where it gets interesting is the collapse in the participation rate from 66% to 63%. The labour force survey suggests only 210,000 people joined the unemployment queue with the rest dropping out. This conveniently keeps unemployment at 7.1%, not the 12% other measures are showing.

When asked in the survey "are you looking for work", it appears for various reasons a large number of people are saying "no".

[3] Charts with global growth rates https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020

JobSeeker numbers reveal the true damage. Numbers suggest everyone who lost a job is now on JobSeeker – even if they tell the Bureau they are not looking for work. The JobSeeker eligibility requirement of “actively looking for work” has been temporarily waived, but will return shortly.

Then there is JobKeeper. This is designed to keep people employed even if they are not working – or are working fewer hours. The $1500 fortnight payment, designed to roughly match the minimum wage, is paid through the employer in arrears. Businesses must have suffered a 30% fall in turnover if less than $1bn or 50% fall if greater than $1 billion. Numbers on JobKeeper are estimated to be 3.5 million, after a mistake initially predicted 6.5 million, or half the workforce.

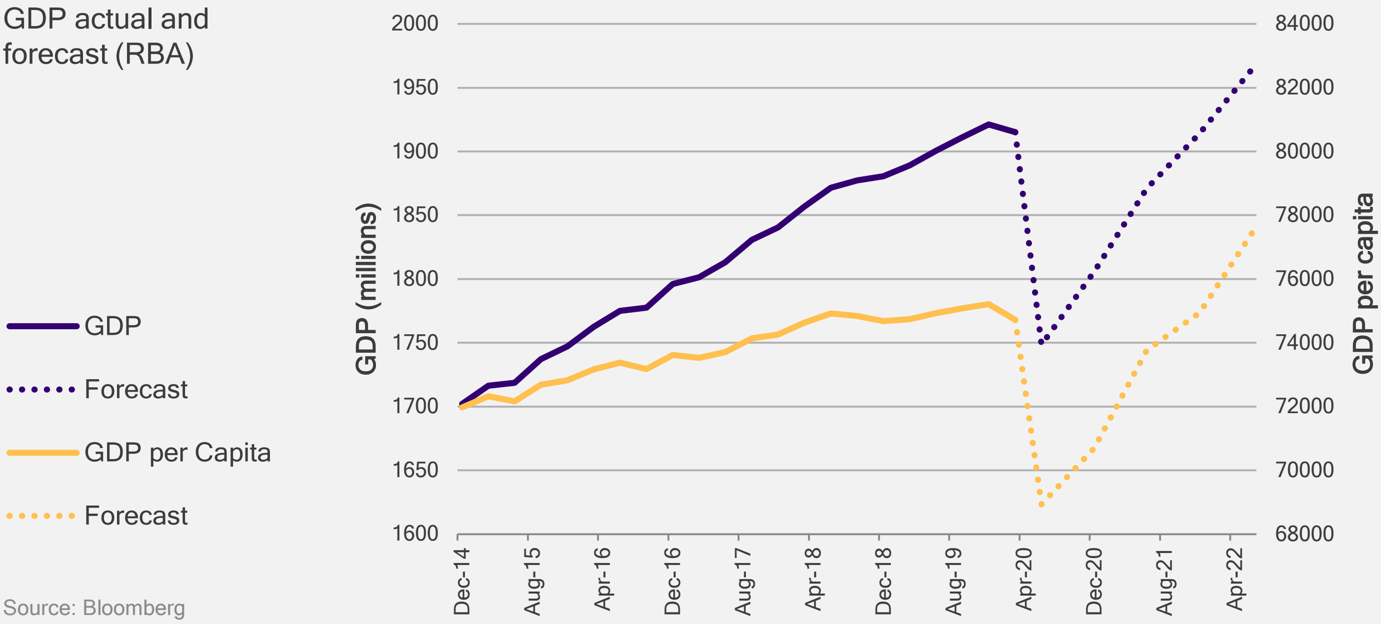
JobKeeper is scheduled to end on September 27 although it may be tightened rather than abandoned all together. No system is perfect. Some businesses believe they are more viable while closed under JobKeeper, which the government doesn’t want to encourage. For smaller businesses 80% turnover means losing JobKeeper – while also likely remaining unprofitable.

Gross Domestic Product

GDP is a volume-based measure. It’s called a chain volume because it’s linked quarter by quarter. There are three approaches to measuring chain volume – income, expenditure and production. Headline GDP is a simple average of the three.

In volatile times like this GDP can be confusing because it’s always reported as a growth number. The real question is how long it will it take the economy to get back to pre-COVID levels. The following graph shows actual GDP rather than the rate of change. The graph also shows GDP per capita, a better measure of productivity in the economy.

Chart 2.
GDP actual and forecast (RBA)



Source: Bloomberg

It will take until early 2022 for the economy to return to its December 2019 size, based on estimates from the RBA's May Monetary Policy Statement.

The RBA has tended to overestimate GDP in the past five years. Health outcomes make forecasting extremely difficult of course, but this assumption looks optimistic.

Viewed from a GDP per capita basis, however, the picture is less dramatic. Almost half of Australia's GDP growth over the last decade has been due to immigration. Australia's population growth has now collapsed and is unlikely to resume to pre-COVID levels for a number of years. This may mean GDP per capita has a better chance of improving.

Inflation and wages

Forecasting medium-term inflation followed some simple rules over the past 25 years. From 1993 to 2012 tradables (40% of CPI) were largely flat. Non-tradables (60% of CPI) were 4%, landing around the 2.5% target. In the last decade non-tradable inflation started to fall to around 3%, led by health and education. This meant CPI settled closer to 2%.

Even before the crisis non-tradables were beginning to slip to 2% and CPI closer to 1.5%. This was largely due to a fall in housing (rents, building costs and utilities), which we viewed as cyclical, not structural. This meant we entered 2020 sharing the RBA's confidence that CPI would drift back to 2% over 2020 as population growth and a lack of new building activity kicked in. COVID-19 has shot down that view.

The story of the economy is now one of widespread excess capacity. Shutdowns meant demand and supply were both hit. Coming out of shutdowns there are pockets of demand exceeding supply as global supply chains have been hit. However in the larger items – particularly labour – excess supply dominates.

Joining this mix is a move to wage freezing. This is led by governments but is also likely in the private sector. The recent minimum wage decision gave a 1.9% increase, down from 3% or higher compared to recent decisions. However as the pool of labour supply increases in many areas, new employees may come in on lower wages.

The real area of concern for inflation is rents. Rents make up 8% of the CPI basket, large enough to move the dial overall.

In pockets of inner-city Sydney and Melbourne, rents are already down about 6%. The levelling of the population means negative rent growth will spread to wider areas in these cities, which rely heavily on students and international workers for tenants. Other cities and rural areas may be less affected. But if rents were to fall 3% nationally this would feed into a 0.25% fall in inflation. There may also be second-round effects.

Until recently the RBA was happy to forecast and accept 2% CPI as the long-term average, despite a formal 2-3% target. Markets now have that closer to 1.25% over the next decade, after falling as low as 0.5% at one point. From a bottom-up perspective even 1% looks optimistic over the next few years.

CPI will be negative 1% or even lower in the June quarter, largely due to free childcare during the quarter. This will be removed, but an era of frozen costs seems here to stay across wide areas such as education, healthcare and government charges.

Outlook for markets

Excess supply in the economy will be with us for at least the first half of this decade.

Structural forces already in place were accelerated by COVID-19 and low GDP and inflation have pushed rates close to zero. The RBA believes negative rates do more harm than good, so they have stopped at zero. The stimulus required from monetary policy for a crisis of this scale was not there – otherwise rates would now be -3%.

Unconventional policy has held down term rates but this really only helps around the edges. Put simply, the RBA has done an excellent job from a liquidity role during this crisis – but from an economic stimulus role it has turned up with a knife to a gunfight.

The federal government now has all the firepower. The initial response to the crisis has been excellent overall. Fiscal policy needs to more permanently enter a new era. Ghosts of Tony Abbott's debt scaremongering still seem to have an influence in Canberra.

Already there is talk of how we are going to pay for all this stimulus and that we are labouring future generations with our debt. You would think the government is a household; with a printing press out back it is not. If Australia is to avoid a lost decade we need to get comfortable with government debt sooner rather than later.

Short rates stuck at zero mean longer rates will also be supported. Any sell-offs in bonds as the economy opens up and data picks up should be bought into. Term premium should not drift higher despite the usual scaremongering around money supply pushing up inflation.

The same voices were out there after Quantitative Easing during the GFC. Once again they will be disappointed. One of the best trades earlier in the decade was harvesting the high carry and roll available. Levels today are not so generous, but still offer good value.

Conclusion

Australia has begun the long, slow grind of re-opening the economy.

Some damage will be repaired quickly while other damage has been terminal. As always, health outcomes partly hold the key to the speed of the recovery. However the federal government is now front and centre and its actions can either prevent or cause a double-dip recession. The more timid their fiscal policy, the longer, deeper and more painful the slowdown.

Bond markets will remain well supported. Plenty of countries have been down this path before us and so far only the US managed, at least for a while, to emerge from the anchor of zero rates. They look like the exception, not the rule.

The grab for yield is once again upon us. For now it is a trend you must go with rather than fight.

We remain long duration and in portfolios with credit overweight investment grade. These themes have further to run in the quarters ahead.

Credit

Tailwinds for credit

George Bishay
Portfolio Manager

Credit markets had a strong quarter following the chaos of March. A number of key policy decisions taken by central banks in mid-March provided a bedrock for a strong recovery in credit spreads. We also saw somewhat better health and economic outcomes through May and June -particularly in Australia. However these are being tested in July.

The Reserve Bank introduced Yield Curve Control in mid-March, anchoring 3-year rates at 0.25% for at least three years. This started a grab for yield – or as bond managers call it, “carry and roll”.

Bonds with maturities fewer than five years across the spectrum were huge beneficiaries as one element of uncertainty was removed. The RBA also started a Term Funding Facility (TFF) for banks, providing 3-year funding at a super-cheap 0.25%.

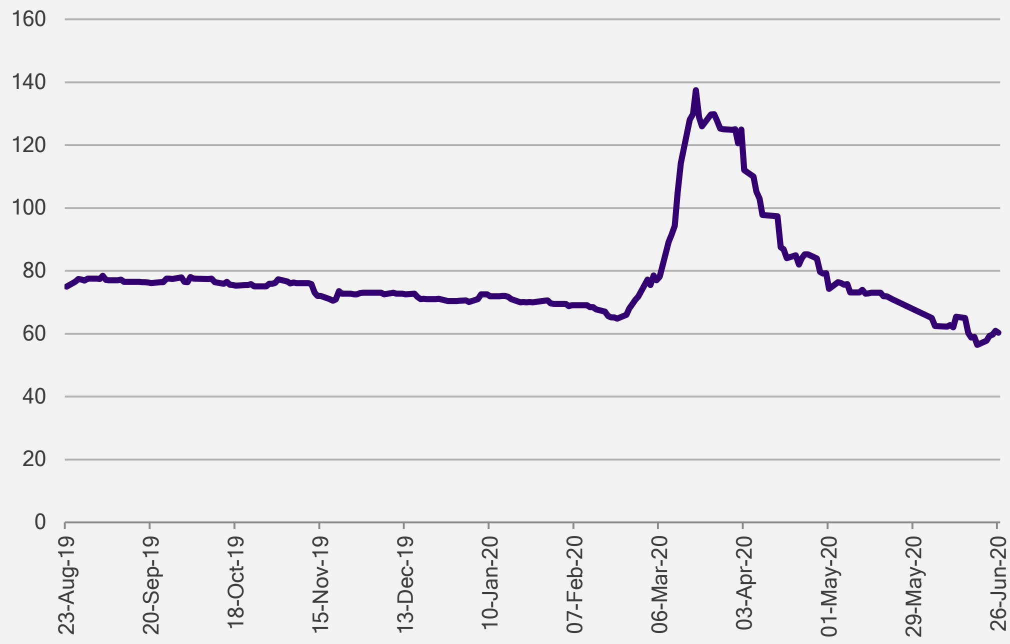
There are limits on this, but it has removed the banks’ need to issue term funding for the rest of the year. The take-up of the RBA’s TFF has been gradually increasing over the quarter, with total drawdowns to date of just over $A12 billion out of a total funding allowance of $A135 billion.

Bank spreads are now tighter than before the crisis, providing a knock-on effect to other credit sectors.

The third measure the RBA took in April was to widen repo eligibility to include senior AUD issued investment grade credit. This stopped short of the actual buying of corporates which a number of other central banks undertook. But the impact gave another strong tailwind to credit spreads.

This has seen spreads between non-financial bonds and financials widen compared to historical levels. The typical spread of 20bps is now sitting at 60bps as lower bond issuance combines with strong demand for higher-rated banks bonds.

Chart 3.
5yr senior bank paper last 12 months



Source: Bloomberg

These three RBA policy decisions were seen as part of a "whatever it takes" mantra by global central banks and governments. In past decades we've had the Greenspan put, the Bernanke put, the Yellen put and now clearly the Powell put. For Australia you can throw in the Lowe put.

The perception is that if conditions deteriorate again central banks will have your back. As Virgin Australia discovered it is not limitless. But for key locally-owned firms in significant industries, being part of Team Australia has its benefits.

Governments around the world are also deploying significant fiscal packages to support employment and stimulate economies. These have encouraged equity and credit markets.

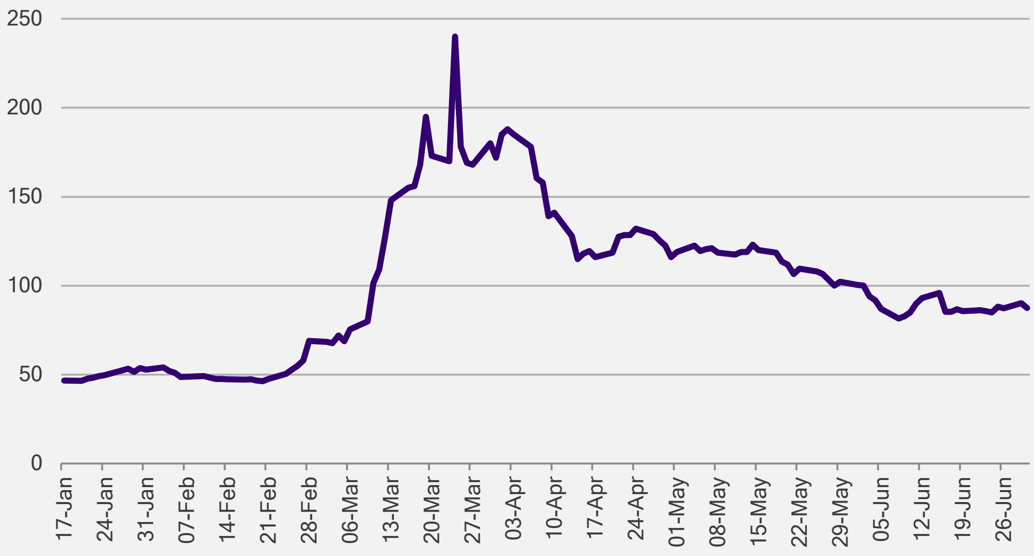
In the medium-term the focus of markets will switch back to the underlying credit fundamentals of companies.

Many companies across the globe improved their credit quality by raising equity to support their balance sheets. We have favoured those companies keen to keep gearing under control and protect their credit rating in the face of potential asset write-downs. We are also watching closely the dynamics from this crisis impacting different sectors in the long term. There is no doubt the world has changed, which will bring permanent damage to certain industries.

The Australian iTraxx index (Series 33 contract) traded in a very wide 115bp range finishing the quarter 87bps tighter to +88bps.

Chart 4.
Australian iTraxx

last 6 months



Source: Bloomberg

Physical credit spreads were generally narrower, on average tightening 18bps for the quarter. The best-performing sectors were domestic banks, telcos and supranationals narrowing 57bps, 45bps and 19bps respectively. The worst-performing sectors were infrastructure and Real Estate Trusts (REITs) which widened 32bps and 13bps respectively.

New issuance picked up in May and June. Brisbane Airport (BBB) launched a 6-year and 10.5-year tranched deal. The book received $1.75 billion in orders over both tenors and $850 million of bond issuance. On the back of strong demand and attractive pricing the 6-year and 10.5-year tranche pricing tightened 35bps during the offer.

Other issuance in the corporate bond market included Westlink M7, the 50% Transurban-owned entity that operates the M7 concession around Sydney. It issued $155 million in 10-year bonds. The deal was 7.6x over-subscribed which saw its pricing tighten from first indication of 225bp to 215bp. It ended at 185bp. Singtel Optus got in on the action with a 5-year and 10-year bond issuance for a total of $850 million on a total book of $2.8 billion (3.2x over-subscribed).

In the supra-national space the National Housing Finance and Investment Corporation returned to the market with a very successful $562 million 12-year social bond. An Australian government guaranteed issuer, it came at 38 over Australian Commonwealth Government Bonds and is now trading at 18 over.

Overall most credit outperformed government bonds, helped by swaps spreads going further under government bonds.

Our outlook is still positive. However we remain cautious with the slowing pace of spread-tightening as we test multi-year tights in some sectors (domestic financials). Uncertainty stills exists in other market sectors.

Bid-side liquidity has significantly improved. Bid offer spreads compressed as many banks returned to the market after an absence in March and early April.

The balance between technical factors – such as central bank support, driving spread performance and the longer-term impact of the virus and subsequent economic fallout – remain critical to the future performance of credit markets in the months ahead.

Cash

Liquidity everywhere - the chase for yield

Steve Campbell
Portfolio Manager

The Reserve Bank's Statement on Monetary Policy in May contained its forecasts for the Australian economy out to June 2022.

The statement highlights significant headwinds ahead for the Australian economy, even allowing for the fact that some forecasts may be too pessimistic.

In its most recent economic forecasts, the RBA revised down economic growth for the year to June 2020 by almost 10% to -8%. For the year to December economic growth is forecast to be -6%, a downward revision of 8.7%.

This would normally result in an aggressive cut to the cash rate. But with a starting point of just 1.50% from mid-2019 – and the RBA's aversion to negative interest rate policy – we have seen the cash rate cut by just 125 basis points.

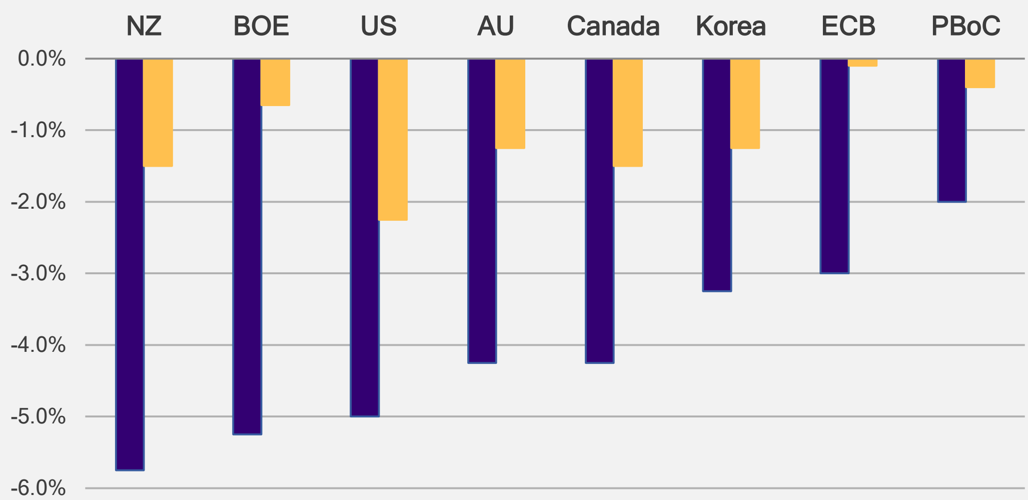
If the magnitude rather than the level matters, it's paltry when all else is considered. Contrast this with the GFC experience and the RBA's forecast revisions around that time.

For the year to June 2009, economic growth was revised down from growth of 2.25% in August 2008 to -1.25% in May 2009. A 3.5% fall in forecast economic growth saw the cash rate cut from 7.25% to 3% versus a 10% fall in forecast growth that has seen the cash rate cut from 1.50% to 0.25%.

The RBA is not alone in the limited ammunition available via conventional monetary policy.

The following graph shows the total changes to cash rates during the GFC and the most recent moves due to COVID-19.

Chart 5.
Traded margin - Credit FRN index



GFC
COVID-19

Source: Bloomberg

What does this mean going forward? The RBA has moved into more unconventional areas with the use of yield curve control and the term funding facility. With the damage wrought on the economy, further stimulus is warranted – be it fiscal or monetary.

Modern Monetary Theory is something that will garner more and more discussion in this period. The output that has been lost as a result of COVID-19 will take a long period to recover.

For cash investors returns are going to remain extremely low. If other central banks implement negative interest rates it cannot be ruled out here either. Although the RBA certainly won't be leading the charge into the next wave of negative rate club members.

ESG

Offering security during uncertainty

David de Ferranti
Portfolio Specialist

This quarter we saw COVID-19 impact the way businesses organise physical workforces. Social distancing measures closed doors across industries such as the local cafe, a favourite hotel or the office foyer. Despite difficult and ongoing challenges posed by such restrictions, it is encouraging to see new doors opening for some of those most at risk in the current environment.

Those in need of more affordable housing options – such as disadvantaged youth, the homeless and victims of domestic violence – will be among the beneficiaries of significant proceeds raised by a social bond issued in Australia last month. The deal from the National Housing and Finance Investment Corporation (NHFIC) amounted to A$562 million. It was the largest amount raised by a domestic social bond to-date. The issuance was well-received by investors and Pendal's sustainable fixed interest strategy was able to participate.

A greater need

In our Beyond the Numbers report we have written about the positive impact Community Housing Projects (CHPs) financed by the NHFIC can have for individuals at risk. Now, during the coronavirus crisis, affordable and social housing providers are even more critical. This is true not only for those impacted by reduced employment options. The benefits also flow to the residential construction sector, which brings broader benefits to the Australian economy amid a very tough economic outlook.

Hit to individuals

Domestic employment data shows the virus's severe impact on our labour market. Some 664,000 jobs were lost between March and June this year, bringing the unemployment rate to 7.4%. The percentage of those seeking more hours and categorised as underemployed rose to 11.7% (Chart 6). Many individuals left the labour force altogether, reflected in a lower participation rate. This led to a dramatic drop in the number of total employed across the country (Chart 7).

[1] https://about.bnef.com/blog/sustainable-debt-sees-record-issuance-at-465bn-in-2019-up-78-from-2018/#_ftn1

Chart 6.
Underemployment vs unemployment

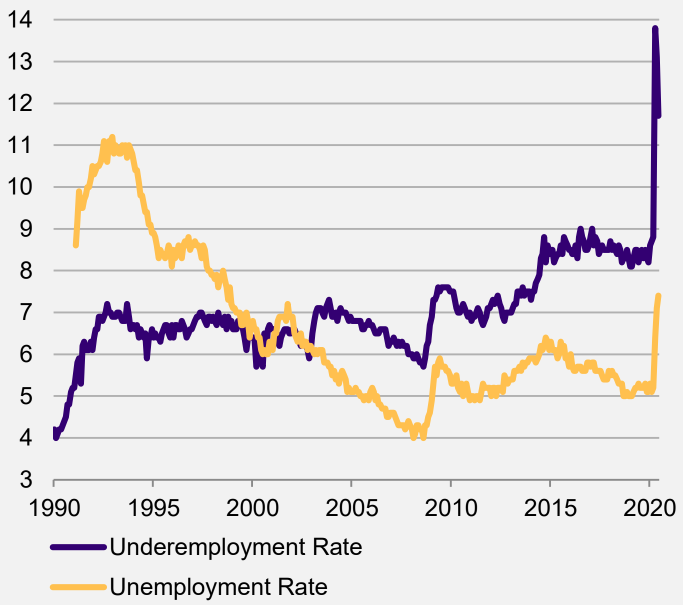
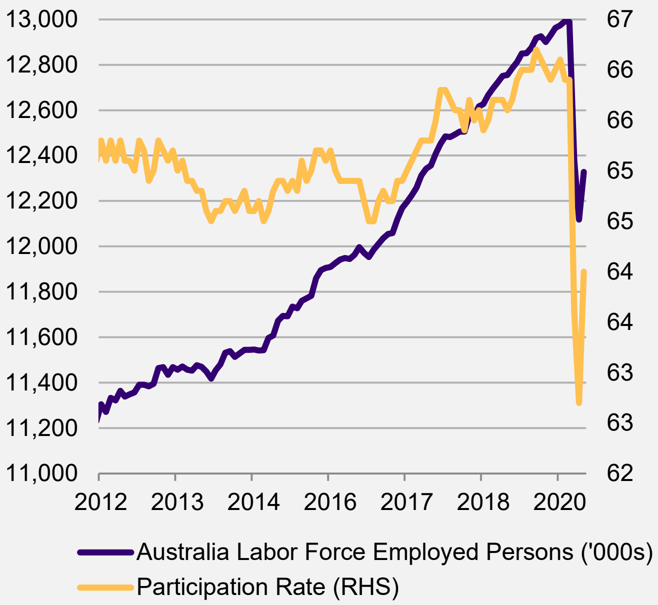


Chart 7.
Underemployment vs unemployment



Source: Bloomberg

The government's JobSeeker and JobKeeper subsidy packages have offered some reprieve to those who have found themselves in financial distress. However these stopgap measures do not address core issues faced by financially disadvantaged individuals over the longer term. Even with JobSeeker payments, only 1.5% of rentals are considered affordable, while with no JobSeeker rentals in the majority of Australian capital cities are unaffordable.[1] Before the pandemic there was already a significant supply shortage of affordable and social housing. Australian Institute of Health and Welfare data shows roughly 140,000 Australians were on a waiting list for social housing, often equating to years in the queue.[2]

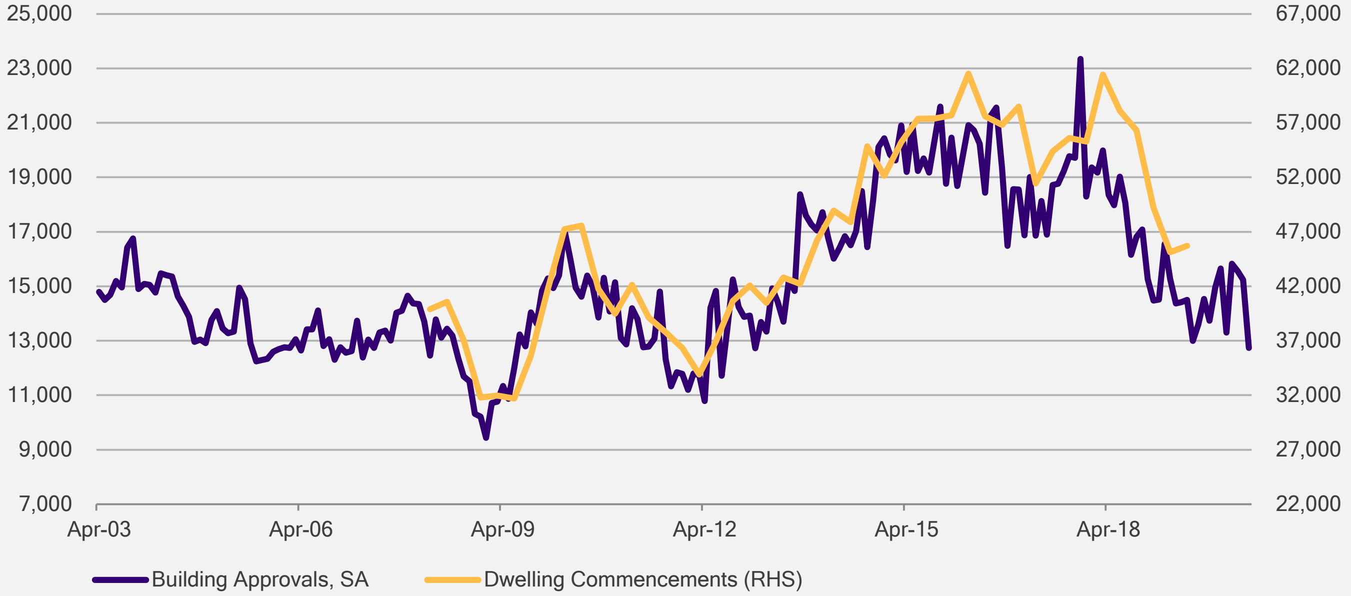
Certain demographics continue to be disproportionately affected by housing-related challenges. This includes women living in regional areas. Roughly one in eight have been homeless in the last five years and one in five know a homeless woman, according to the YWCA's *Women's Housing Needs in Regional Australia* report. When asked what would improve their situation most, about half responded with a reduction or subsidy of housing costs.[3]

Construction downturn

Beyond the negative impact on individual financial situations, COVID-19 threatens further weakness for the residential construction industry, where activity was already on a downward trajectory. New commencements are expected to follow building approvals lower. HIA forecasts a fall in dwelling starts to 134,000 in FY2021, down from a peak of 230,000 in FY2018. This reduction in new supply of homes threatens not just the at-risk individuals noted earlier, but the livelihoods of those in the residential building industry.

1 Rental Affordability Snapshot, April 2020
2 AIHW, Housing assistance in Australia 2019
3 YWCA, Women's Housing Needs in Regional Australia, 2020

Chart 8.
Building approvals vs commencements



Source: Bloomberg

Making a positive impact

The proceeds of the latest NHFIC social bond will not resolve the issues described here. But they will make a significant contribution to the lives of those in need of housing assistance and help keep a number of tradespeople in work. Some 7100 new homes and management of existing properties have been financed by the NHFIC issues to-date.[4] The latest deal financed 10 CHPs, which have operations in a range of regions and are targeted at different demographics.

This includes Women's Housing Limited which received a $9 million loan to refinance existing debt and buy new properties.[5] These new properties will house women escaping domestic violence, who will be able to pay a rate much lower than the market rent. This helps essential workers in vital services such as healthcare and hospitals live closer to their workplaces.

The biggest recipient of financing was Sydney-based SGCH, the largest CHP in NSW. Its loan will help support 305 existing dwellings and 235 new homes in Australia's most expensive rental market. The low rate provided through the NHFIC facility was estimated to save $40 million over its term – funds that can be invested in hundreds of other homes.[6]

Other recipients included Argyle Housing which supports regional communities via affordable housing. Recent projects have included new homes in Griffith for workers in the agricultural industry, as well as areas with at-risk youth in Wagga Wagga. Housing Choices Tasmania received financing for new developments across the state.

4 NHFIC, NHFIC finalises largest social bond issue from an Australian issuer, 2020
5 Women's Housing Limited, 2020
6 SGCH, 2020

New homes created by these CHPs will make direct and indirect contributions to the residential construction industry. For each $1 million of output for the sector, nine jobs are supported and $2.9 million of output and consumption is created for the broader economy, the NHFIC estimates. This multiplier effect is calculated as the second largest across all 114 industries in the Australian economy.[7] Powerhousing Australia estimates the construction of a standard stand-alone three-bedroom house helps 43 trades and sub-trades gain employment.[8]

Conclusion

In this landscape of lockdowns, social distancing and housebound workers, a place to call home is of paramount importance. A safe and stable home has become even more critical. Building new homes for at-risk individuals brings security to the recipients and generates broader benefits to the Australian economy at a vital juncture. As investors in these bonds, we believe these outcomes also allow our clients to have a positive impact on fellow Australians when they need it most.

[7] NHFIC, Building Jobs: How Residential Construction Drives The Economy
[8] Powerhousing Australia, Australian Affordable Housing Report F2021, 2020

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or visit **pendalgroup.com**