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Weekly BIDS note

August 28, 2020

Another week, another $21 billion of federal government issuance.

Only a few years ago in 2008 the federal government's total outstanding debt was $50 billion. The book size for their new 2031 this week was $66 billion.

They printed $21 billion at a yield of 1.055%. Total outstandings are about to hit $750 billion and could reach $1 trillion by 2022.

Where does all the money come from?

It's basically the same money the government is spending every day coming back to them. The budget deficit means more spending than taxing, leaving excess money floating around the system.

It has to find a home and it either ends up at the Reserve Bank in Exchange Settlement Accounts or back at the government via the AOFM.

Banks don't need that money to lend – they create their own money. Of course all money is fungible so the public and private system may seem blurred. But effectively they operate separately. It's a monetary system that guarantees federal government issuance always finds a home. Tasks may seem large but the AOFM can relax.

Offshore investors remain good buyers of Australian denominated debt. Japanese investors are active in buying longer-dated semi-government bonds, with their life companies passing $10 billion since the COVID crisis.

Asian private banks remain active in Australian credit markets. European investors are mainly focused on federal government bonds. The Australian dollar is likely to continue to grind higher which may temper demand at the margin. But any yield over 2% in a AAA global developed market is chased in a world flushed with cash.

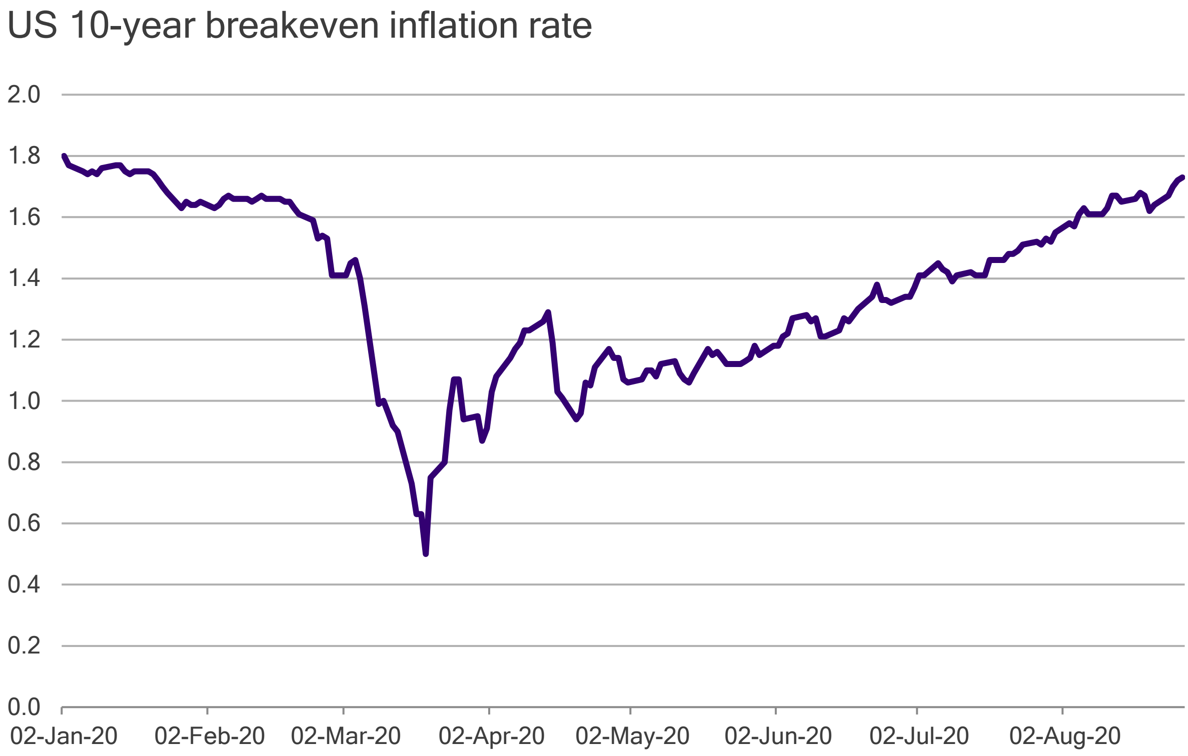
Economic data was sparse this week. The weekly payroll numbers showed the impact of the Victorian shutdown. Victorian jobs are now 7.8% below pre-COVID levels. Nationally they are down 4.8%.

Western Australia leads the way with jobs down only 1.9%. There will be ebbs and flows but with a consensus (including the RBA) forecast of 10% unemployment by year's end, poor data is not surprising and has had little impact on markets.

All eyes have been on the US Federal Reserve and post Jackson Hole announcement.

The key takeaways – which didn't surprise the market – were the average inflation targeting and expanded definition of maximum employment. This, in a nutshell, allows the economy to run hotter before it taps the interest rate breaks to prevent a wage-driven inflation outbreak.

The market continues to believe the Fed can increase inflation. Since the lows in March we have seen a dramatic increase in inflation expectations as seen by the Breakeven inflation rate.



Source: Bloomberg

This saw a jump up in US bond yields and the curve steepen to levels to not seen for over two months.

Of course what happens offshore also impacts us and Friday morning saw Australian 10-year bond yields pass 1%.

Typically at these levels offshore buyers and domestic buyers come in to take advantage of higher yields.

We continue to see inflation risks to the downside in Australia and the opportunity for yield curve to flatten. Any opportunities to own AA government bonds at these yields – and in a continuing low yield world – are too good to refuse.

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