

Pendal  
Bond, Income &  
Defensive Strategies

# Australian Quarterly Update

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October 2020



## Rates

RBA - the final act  
...and now for something  
completely different?



Tim Hext  
Portfolio Manager

“The Board views addressing the high rate of unemployment as an important national priority. It will maintain highly accommodative policy settings as long as is required and will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2-3 per cent target band.”

- RBA Statement, October 6

“Once the recovery has taken hold and the unemployment rate is on a clear path back to pre-crisis levels, comfortably below 6 per cent, we will move to the second phase where there is a deliberate shift from providing temporary and targeted support to stabilising gross and net debt as a share of the economy.”

- Josh Frydenburg, 2020 Budget speech

## Massive Stimulus

Fiscal and monetary policy are both foot to the floor. Fair enough during the crisis. But if we take these comments at face value they will likely stay there long after the crisis has passed. The RBA hasn't seen inflation sustainably within the 2-3% target band for almost seven years. They forecast it, but rarely saw it. The government has never been so explicit with an economic target. But likewise, getting unemployment comfortably below 6% may take quite some time.

Earlier in the year we were concerned a conservative government would wind back too quickly on stimulus. 180 degrees wrong on that. They have outdone previous Labour governments with a massive stimulus that dwarfs anything seen during the early 1990s recession or the GFC. Does the demand side return far quicker than the supply side in the economy? And what does that mean for policy and markets?

## The RBA in November

The RBA has let us know there will likely be an encore in early November to their 30-year rate cut performance. In March it seemed they had effectively reached zero bound rates and were strongly averse to negative rates. Yet they are signalling a few more drops can be squeezed. More importantly, having downplayed Quantitative Easing, they will likely unleash what most central banks did over a decade ago – a quantity-based bond-buying program.

The RBA has copped decent criticism in recent times. Paul Keating, using his usual colourful turn of phrase, referred to them as the “high priests of the incremental”. Even more scathing was Keating’s nickname for the RBA when he was in government: the “Reverse Bank”. The Australian economy has performed far better than was forecast in March. But it will have taken eight months to add to those bold and timely March moves. Maybe the excitement of the massive fiscal stimulus in the budget has seen the RBA wanting to still be part of the show. But are they too late?

The major impact of monetary policy has not been whether the cash rate is 0.25% or 0.1%. Rather interest rates in the real economy have plunged almost 1% since April since the RBA flooded the banks with cash. Term deposit rates are down almost 1% since April and mortgage rates by almost the same. The term funding facility, set at \$84 billion to September, has been extended to June 2021 with an extra 2% of outstanding credit on offer plus multiples of new lending. Almost \$200 billion is expected to be drawn down by the middle of next year.

As a result banks don’t want your cash. And they are keen to lend you money. Not surprising then that rates are plummeting. That is the whole point. Banks are now effectively public utilities – by mid next year receiving four times more money than the federal government has so far through RBA bond buying and almost 20 times the State governments. Perhaps that is why quantitative buying will be introduced in November, to help bridge this gap.

It turns out the RBA has a printing press and knows how to use it. And well they should in a crisis like this. Just don’t call it monetary financing. Washing it through the market via governments issuing to markets which then sell bonds to the RBA enables the illusion of separate decisions. The RBA can claim quite rightly it is targeting keeping term rates down. The government is just focused on doing what is needed fiscally. However by buying bonds the RBA is helping fund governments. There should be no shame in this. Hands are not soiled. The RBA governor told the Parliamentary Economics Committee that “the separation of monetary policy and fiscal financing is part of Australia’s strong institutional framework”. However with rates now at zero – and unlikely to have any meaningful take-off – big deficits and the RBA buying bonds will be more than a coincidence in future downturns. Just witness QE1, QE2, QE3 and now QE4 in the US.

The government paying interest to a government body, the RBA, is right now a zero sum free lunch. The only problem might be inflation, or the “inflation tax” as Dr Lowe refers to it. Again, isn’t that partly the point – to get inflation off a dangerously low floor and back above 2%. The inflation tax is will be welcome by all at this point, particularly the RBA.

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## Where to for the economy from here?

The RBA signalling likely upcoming actions meant September was a strong month for our Australian bond funds. We remained long duration as a very good risk/reward trade. Market pricing means we don’t need to wait for the actual easing as it is now almost fully priced. The impact of Quantitative Easing is not yet fully priced so we have moved our risk to trades based on that being implemented.

But we must be forward looking because eventually economics – not just government action – will play its part in fixed income.

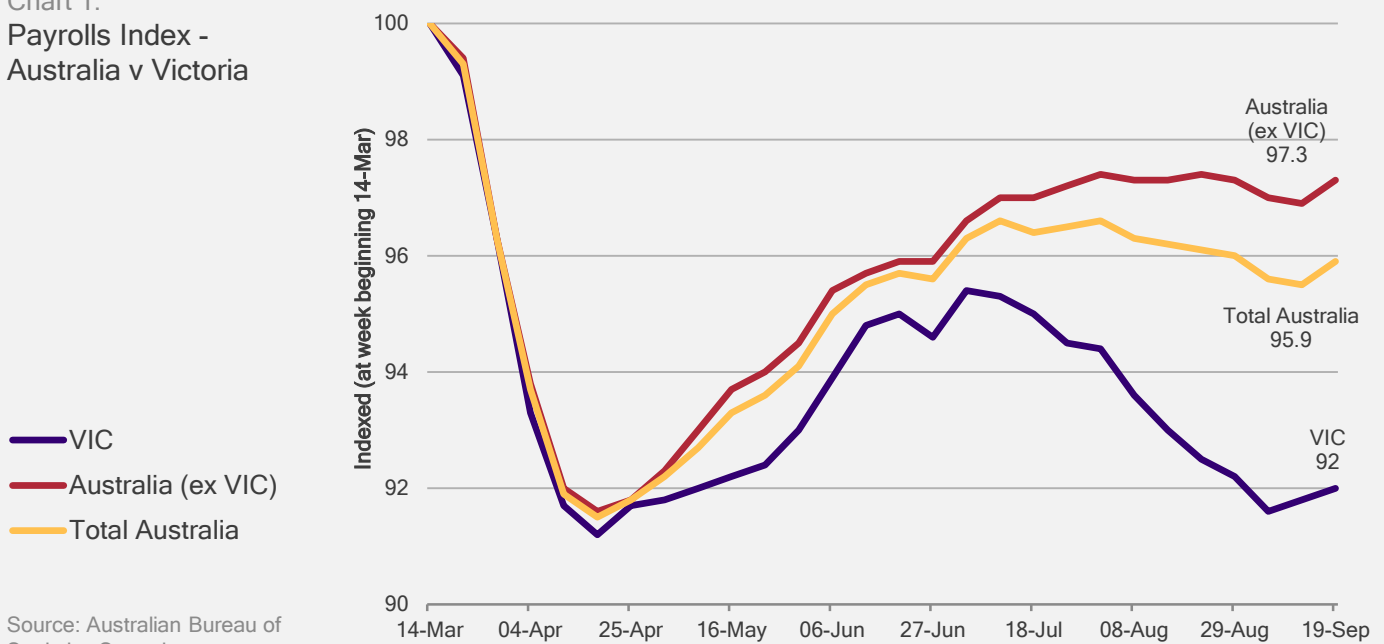
All this leads to three key questions we are asking ourselves as bond managers:

1. The first one we have no answer for – what’s the outcome for virus and vaccines. We read what everyone else does. Like everyone else we cross our fingers that the suppression strategy keeps working. It seems sometime in 2021 we will have a largely effective vaccine – but that’s a base case, not a given.
2. Does all the new fiscal and monetary stimulus come just as the economy is turning? Is it enough or in fact could it prove to be too much? At times like this too much is less risky than too little but the question must be asked.
3. Will inflation remain on the ropes or are the ingredients of a surprise spike being quietly mixed without most people noticing? Crucial to this is how demand and supply come back in the recovery. Is it possible to push up demand without the corresponding supply, creating a mini version of stagflation for a number of years? This is far from consensus, which is why it interests us. It is also a scenario that, being so rare, few have the playbook to manage.

## Growth and Jobs

Outside of Victoria the recovery has been gaining momentum for some time. One of our most timely indicators is the weekly payroll numbers. The most recent numbers leave Australia with a post-Covid job loss of 4%. Excluding Victoria it’s 2.7%. Assuming Victoria catches up in early 2021 this will leave job losses heading back to 2%, or an unemployment rate closer to 7% than the 10% now predicted.

Chart 1.  
Payrolls Index -  
Australia v Victoria

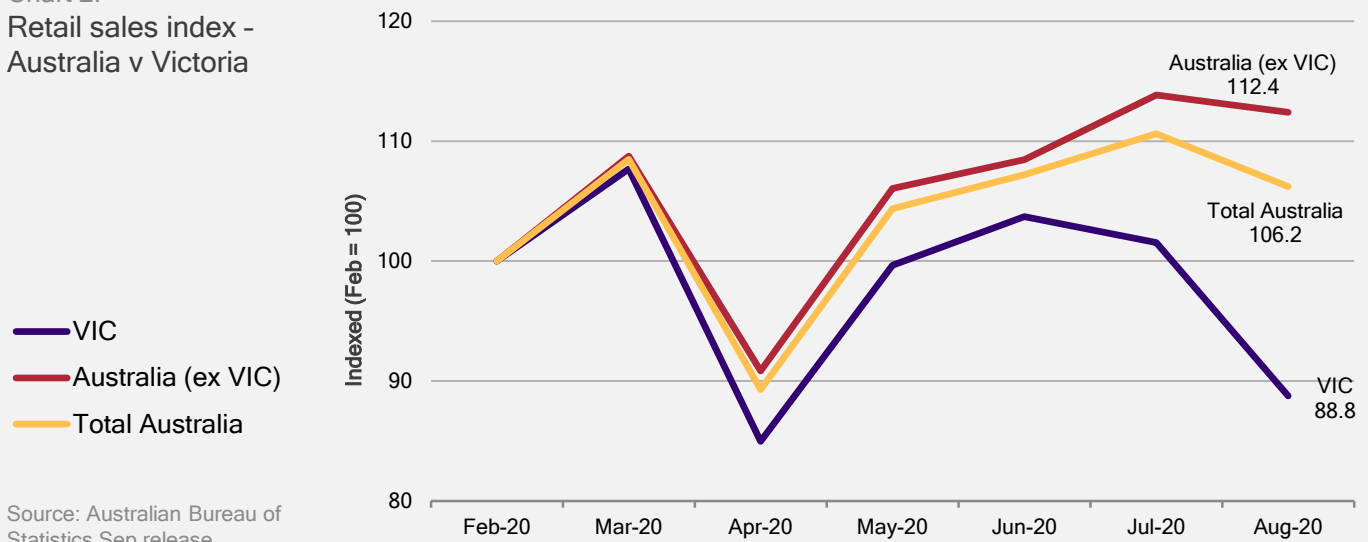


Source: Australian Bureau of Statistics Sep release

The traditional unemployment data shows a slightly lower 3.3%, or 426,000 of jobs lost between February and August. Nearly half were in accommodation and food services, which usually employs 7% of workers. The rest were broadly distributed across transport, education, professional services, manufacturing and the arts. Interestingly retail was unchanged and construction only slightly lower.

Retail sales have been very strong since April. Excluding Victoria they are up 12% since February. It seems those who kept their jobs are buying a lot more.

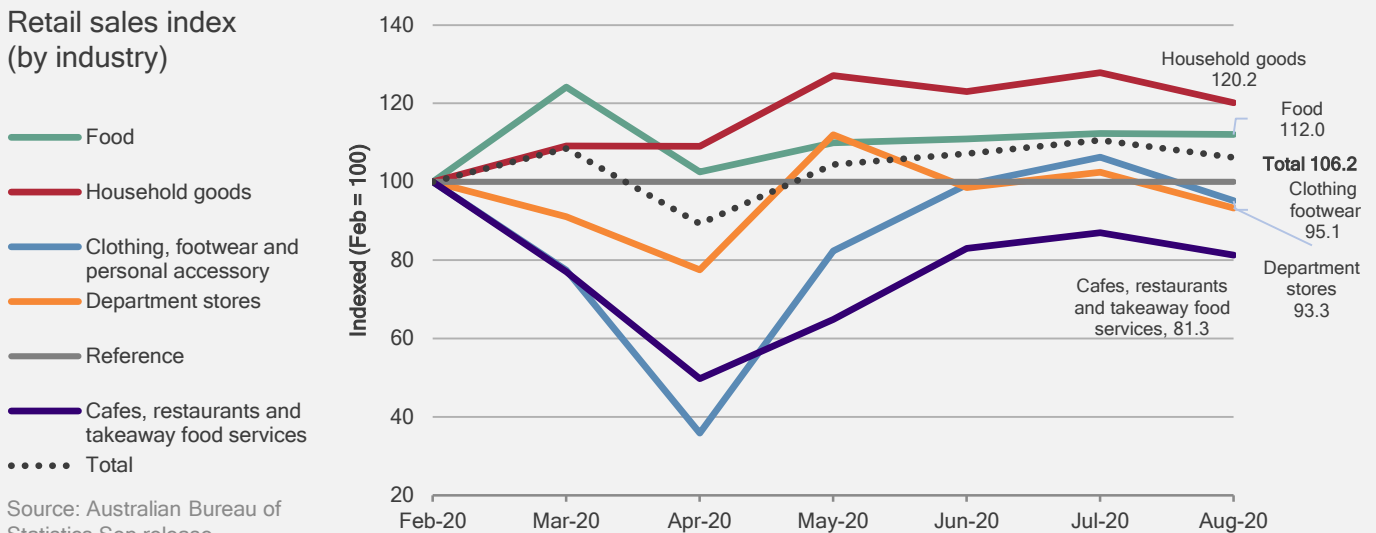
Chart 2.  
Retail sales index - Australia v Victoria



Source: Australian Bureau of Statistics Sep release

The next graph show where they are spending it. Money saved on travel and eating out is going towards food and household goods. The spending on household goods is not just limited to work-from-home technology. Hardware, gardening, furniture and almost any homewares are booming as well – all told up 20%. Share of sales among online retailers has jumped from 7% pre-Covid to more than 11% today.

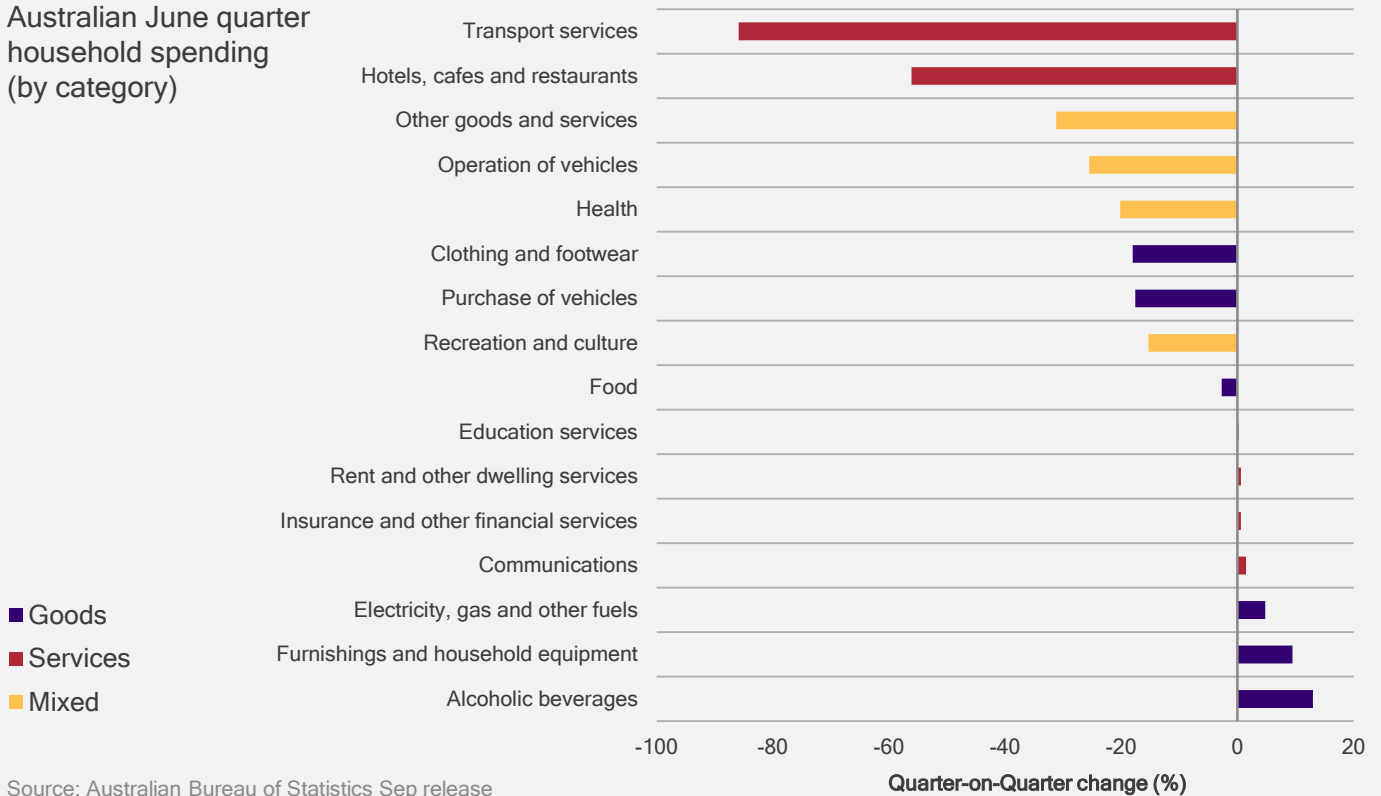
Chart 3.  
Retail sales index (by industry)



Source: Australian Bureau of Statistics Sep release

Retail sales accounts for about a third of consumer spending. So what about the rest – mainly services? A sharp fall in services was almost fully behind the negative 6.3% GDP print in the June Quarter. Unfortunately we only get quarterly ABS data on these. Here was the carnage in the second quarter:

Chart 4.  
Australian June quarter household spending (by category)



Source: Australian Bureau of Statistics Sep release

All the big hits were lockdown-related. While a level of caution persists in using some of these services after lockdowns are lifted, they do largely bounce back, as Sydneysiders can attest to. Transport services was the largest drop in the Q2 data. However Apple Mobility data shows that between January and July in Sydney driving increased 20% after it was down 50% in March. Public transport fell 65% in April but has since returned to be down 40%. These have improved further since.

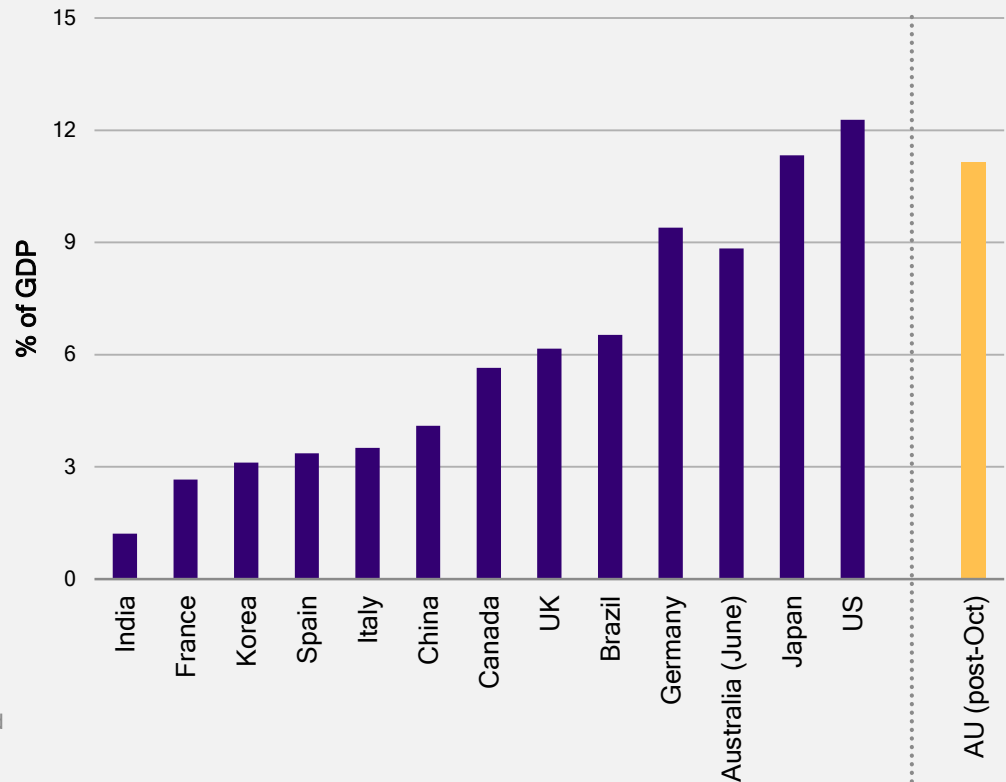
Third-quarter GDP numbers are not released until early December but we continue to monitor timely data to gain a view on how industries are coming back post lockdowns, especially in Victoria. The RBA expects GDP to be back at pre-crisis outright levels by late next year – an outlook we previously thought optimistic. However, with the federal government on board a massive stimulus train, we are warming to this forecast.

Growth through pre-Covid levels will be difficult given employment and zero population growth. Population alone has contributed about 1% to GDP for the past few decades. The recovery will likely look closer to a slightly drawn out V shape than we have previously thought, mainly due to government action.

## The Budget

The budget had big numbers everywhere. It wasn't until I came across this graph from NAB that I realised just how big. During the 1990s recession, fiscal measures peaked at 4% of GDP. The spike in government spending to GDP from 23% to 26% under Wayne Swan during the GFC has been dwarfed by 35% in this budget.

Chart 5.  
IMF estimates of fiscal measures by country



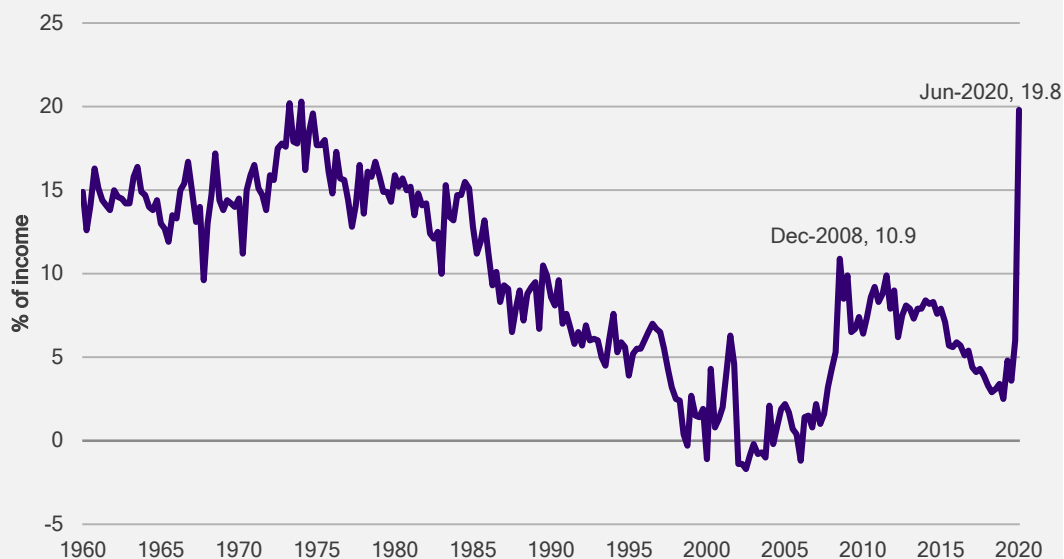
Source: International Monetary Fund  
June release, Australia National  
Budget Oct release

Only the United States has seen larger measures compared to GDP. Given our far better Covid health outcomes and the speed of rebound this is highly stimulatory and changes our narrative from the last quarter. The LNP government has thankfully proven highly pragmatic and less wedded to ideology than was feared. This matters for the size and speed of the rebound.

Importantly JobKeeper and JobSeeker continue to help the 7% to 8% of the workforce looking for jobs. While JobKeeper can eventually be phased out, it is hoped JobSeeker will remain at \$800 a fortnight rather than the unnecessarily mean level of \$550.

If you have a job, tax cuts will add to the big increase in savings, helping build a kitty for when confidence returns. Savings have taken off, returning to levels last seen in the mid-1970s. This doesn't include the early withdrawal of super, which would take the number to 25%. The savings rate will fall as spending returns, but it will remain well above recent times.

Chart 6.  
Australian household  
savings rate



Source: Australian Bureau of Statistics Sep release

Mortgage payment deferrals make great headlines and are very real for many. Estimates are that around 9% of housing loans, or \$160 billion, have been subject to deferrals. As we enter 2021 this will be important to track, particularly when assessing property prices. However less than 8% have a loan to value ratio higher than 90%. Combined with stable or slightly rising house prices negative equity is unlikely to be a problem for many. On the positive side of the equation increased savings and lower rates mean many have paid off the mortgage faster this year. More than 30% are at least three years ahead on repayments.

## Inflation

Between 1970 and 1990 prices went up almost 500%, the RBA inflation calculator shows. Since 2000 the same figure is 61%. Inflation has been crushed, allowing us to largely ignore it. A mining investment boom saw some mild inflation before the GFC but our purchasing power was intact. Asset owners have seen strong returns over CPI. Many well-off retirees actually get richer while not working.

However 30 years of very low inflation is now under threat. In the midst of a recession and after a negative annual CPI print it may seem deflation – not inflation – is the looming problem. We must look ahead and work out how the massive fiscal and monetary stimulus works through the system and what a post-COVID economy looks like.

One thing is certain. The risk of a decent rise in inflation has gone up as central banks leave their foot to the floor until actual, not potential, inflation gets comfortably within their target (the RBA) or even above their target (average inflation targeting from the Federal Reserve). Add to this cocktail massive fiscal stimulus and the goalposts have moved for the first time in decades. The Federal Reserve has shifted the goalposts and priorities from inflation to unemployment. The RBA is not far behind. Markets are ill-prepared.

There are two areas we are keeping an increasingly watchful eye on. First is the way the supply side of the economy emerges from Covid. Monetary policy tools are well equipped to manage the demand side as the RBA showed by tightening in 2005-2008. A tap of the brakes reduces credit demand and generally works to bring demand back towards supply. The strong economy also brings budget surpluses, draining money.



During Covid demand and supply were hit overnight – new ground for the economy. Policy makers went hard early and were largely successful in keeping demand and supply in balance. Stimulus measures will stay in place to maximise demand as we emerge from the pandemic. Unemployment will take time to come down but pent-up spending and new fiscal measures should see demand return more quickly than many expect. Tax cuts will add fuel. Anyone on \$120,000 pa or above just got an extra \$2800 per year, backdated to July 1.

Less clear is the supply side. Some areas such as airlines and retail have seen significantly reduced potential capacity. More broadly, there are concerns that the recovery may not come soon enough for businesses on life support, as pent-up rents and interest payments come due. Residential construction is another area where supply will become an issue. Today’s narrative of low population growth due to no immigration means the talk is all about over-supply. This is leading to a big fall in new construction – the seeds of a future housing shortage once borders reopen.

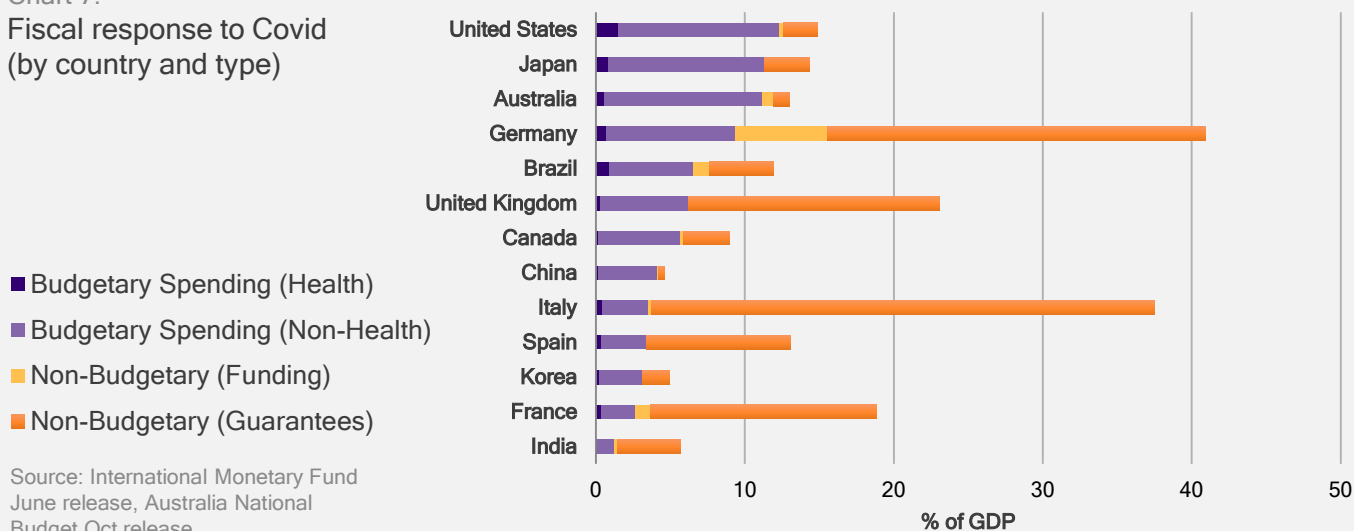
Global supply lines have been impacted. Deteriorating global trade relations mean 30 years of flat imported prices are something we can no longer take as given.

Money supply is the second area we are watching closely. We are less concerned than many about the government creating money through big deficits. This net money does boost the economy as it circulates but ultimately ends up back with the government via borrowing or excess reserves at the central bank.

The potential for an unexpected boom in credit growth is of greater concern for inflation in the medium term. Most money in the system is created by the private sector borrowing from itself. The mixture of a recovering economy and super cheap money could light a long-dormant match. Capital appreciation, not preservation kicks in.

Added to the lifting of spirits in the private sector is the global development of government intervention in private credit markets. This goes far beyond central banks buying corporate debt. Governments are providing guarantees to private sector loans in an attempt to boost credit growth. I was shocked to see the scale of these guarantees shown in a Bank of International Settlements recent paper, especially in Europe.

Chart 7.  
Fiscal response to Covid  
(by country and type)



Source: International Monetary Fund  
June release, Australia National  
Budget Oct release

Banks can't go wrong. Central banks are providing them with almost free money via loans like the \$200 billion Term Funding Facility from the RBA. At the same time governments guarantee the loans made with this money, especially in areas like environmental projects or sustainability. Europe is at the forefront of this but a Democrat government in the US could up the ante. For now Australia is largely avoiding this, maybe due to old memories of the various State Bank debacles in the late 1980s.

So there is plenty to watch. We are watching a number of signals domestically and globally. Excess money supply is at record levels everywhere. Credit growth is low, for now. Trade deficits are low, for now. US\$ weakness is leading to global FX reserves ballooning once more as central banks try to hold their currencies lower. Commodities will be the next movers to watch, particularly soft commodities.

Investors may want to look at cheap inflation protection and which asset classes will and won't perform. We have strong views on this. The odds of higher inflation have definitely gone up as monetary and fiscal shackles are released. Governments will need to make sure welfare keeps pace with inflation to protect the vulnerable. For others without protection it may be a case of inflation eating into future spending power.

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## Conclusion

The next few quarters will be fascinating and potentially full of opportunity. During 2020 the money has been made by following the actions of central banks and governments. Both have revealed they will do whatever it takes, once again giving confidence to risk and helping duration. However this crisis is like no other for 100 years. The usual post-recession playbook will not be enough this time. We are busy adapting our economic models to the new reality of the post-Covid economy. We are making sure we have a suite of real-time indicators as things will change quickly. Most importantly we are looking for cheap insurance wherever we can find it.

Pendal has generally been at the defensive end of fixed interest markets because our belief was interest rates were structurally heading towards zero. For a decade they edged gradually down. Covid just got us somewhere we were going anyway a little quicker. Now we are there. As the RBA potentially delivers its final act in a rate cut cycle lasting almost 30 years (with a few hikes in between) we are making sure we are once again ahead of the game and not fighting the battles of the last cycle. Are we entering an entirely new phase where it is time for something completely different?

We encourage all our existing and potential clients to join us on this journey.

## Credit

### Fundamentals supportive for Australian credit



George Bishay  
Portfolio Manager

Credit markets performed strongly over the quarter. There was small underperformance in September, with credit spreads marginally wider on the back of increasing volatility in offshore equity markets. But in July and August, tailwinds from improving economic data and massive central bank and government stimulus saw major risk on moves, driving asset prices higher.

Risk markets were also supported by stronger-than-expected US earnings results. Earnings for the 2nd quarter vs pcp were down 7% which was 23% better than expected. European companies also surpassed expectations by 33% with earnings falling 19% pcp. On the flip side, the ASX200 underwhelmed with company earnings falling 22% pcp.

Further vaccine hopes also helped drive positive market sentiment as a number of pharmaceutical companies released positive Covid-19 vaccine trial data. The results found the vaccines were safe and drove driven positive immunity responses. The approval of the Abbott Labs rapid antigen Covid test is a positive for markets because it supports returning to work and school sooner. It provides a quick 15-minute result at a very cheap price of \$5 with accuracy in the high 90% range.

Locally, in a supportive move for Australian banks and the economy, the federal government announced a wind-back of responsible lending obligations. Australian banks will now only be required to meet APRA's lending standards, replacing the practice of "lender beware" with a "borrower responsibility" principle. This means banks will be able to rely on borrower declarations when making credit assessments. This development will ensure the flow of credit to the broader economy under exceptional circumstances and improved loan approval times.

The Australian iTraxx index (Series 33 contract) traded in a 29bp range finishing the quarter 20bps tighter to +68bps. The new Series 34 contract ended the quarter at +76bps. Physical credit spreads were also narrower, on average tightening 12bps for the quarter. The best-performing sectors were industrials and resources – both narrowed 25bps. The worst-performing sectors were infrastructure and REITS which only tightened 2 to 4bps respectively.

We continue to be very positive on investment grade credit on the back of extraordinary support measures by global central banks and governments. The recent federal Budget significantly added to this, with government spending at a massive 35% of GDP. Wayne Swan could only manage 26% in the GFC.

Also from a fundamental perspective, many companies across the globe are supporting their balance sheets and improving their credit quality through raising equity. Most credit issuers remain committed to keeping their investment grade ratings.

Excess liquidity in the banking system and current credit spreads against a 0.25% cash rate will continue to attract buyers to the sector, supporting credit markets in Australia.

Supply has also increased in the September quarter with strong issuance in the month of September. We also saw our first Covid issuance – the Shinhan Bank priced a \$A400 million COVID-19 response social alleviation bond, which was more than two times oversubscribed. The proceeds will fund Korean SMEs that have been affected by the pandemic and projects to limit the virus. We didn't participate because we didn't see a link between bond issuance and the impact benefit for our funds. But the strong demand means we expect to see more issuance come to market in this style.

In September 12 borrowers came to market, issuing a total of \$A5.3 billion including 52% in financial and 48% in non-financial deals. This takes YTD issuance volume to \$A12 billion for non-financials and \$A24 billion for financials. While non-financials issuance is running above long-term averages, financial issuance is much lower and likely to remain low. This has led to Australian issuance being much lower than offshore issuance since Covid started – another supportive factor in Australian investment grade credit vs offshore credit markets.

In relation to Covid-19, we believe a more educated and experienced global community will better manage mortality rates, ultimately supporting markets. However, we still have concerns about uncertainty related to the flow-on effect to the global economy and company earnings. We will continue to closely scrutinise developments and assess potential ramifications as they occur.

We are also focused on the US elections and the potential impact on markets. For Australia this is most significant around the impact on US-China tensions and the follow-on effect of global trade. Over the medium-to-longer term the massive current and potential stimulus from policy measures will continue to be supportive for risk assets, which leaves us still very constructive on credit markets.



# Cash

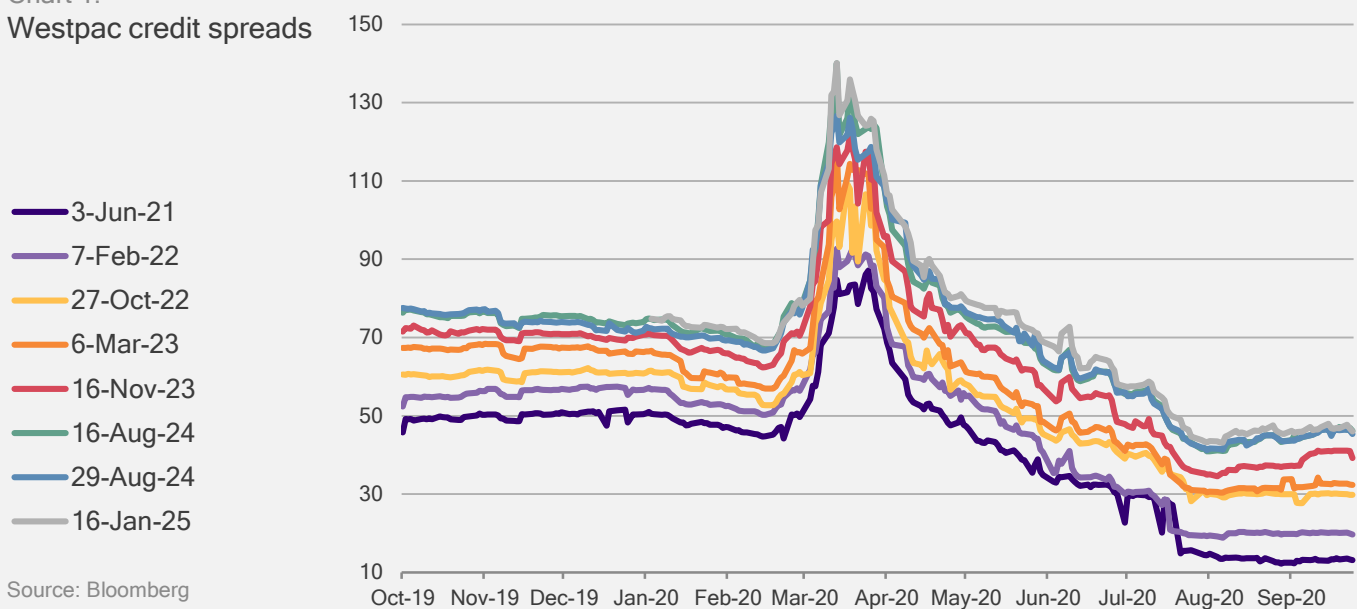
## Impact of government policy on cash markets



Steve Campbell  
Portfolio Manager

The Reserve Bank eased monetary policy further in September when it announced an extension of the Term Fund Facility until the end of June 2021. This facility is available to authorised, deposit-taking institutions at a rate of 0.25% for up to 3 years. This facility now stands at more than \$200 billion. Financial institutions can use this to fund new loans, replace more expensive maturing debt or finance asset purchases such as government bonds that may earn a yield higher than the funding rate of 0.25%. The facility will reduce the amount of bank issuance in the Australian market and has resulted in credit spreads contracting, as shown in the graph below.

Chart 1.  
Westpac credit spreads

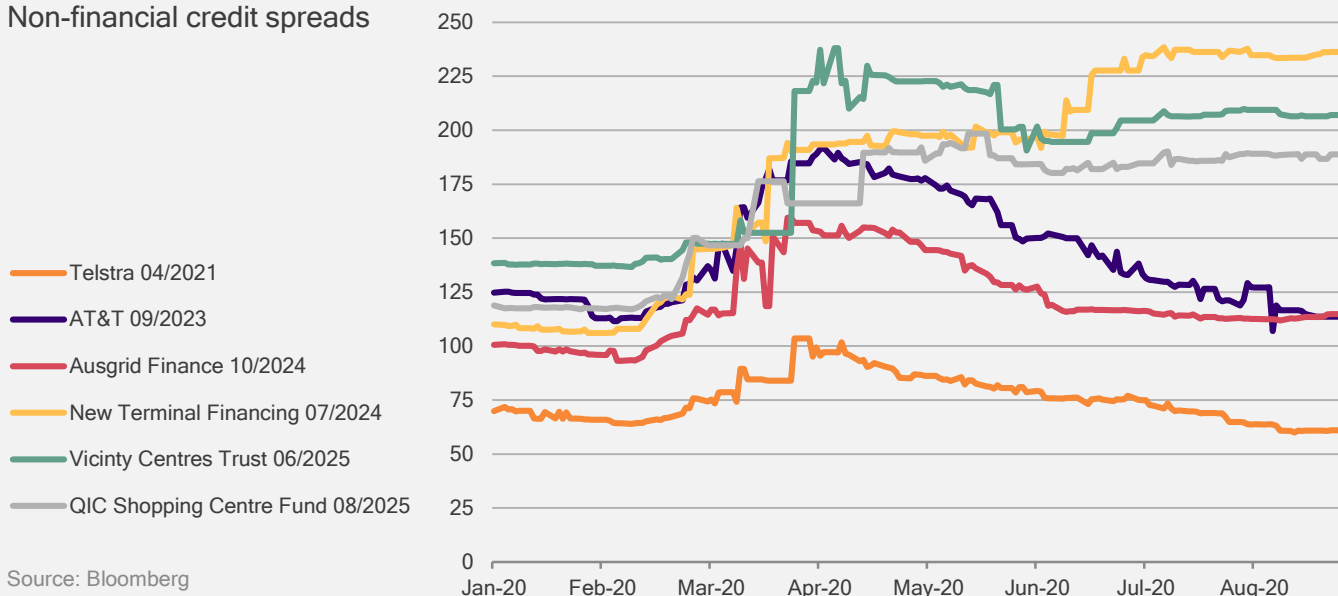


Source: Bloomberg

The graph shows the traded margin, or credit spread, on major bank Floating Rate Notes across various tenors. The credit spread is at least 20 basis points tighter since February across all tenors despite the significant economic headwinds that Australia is facing. You wouldn't normally expect credit to be tighter when, according the RBA's most recent Statement on Monetary Policy, economic growth is forecast to be -6% for 2020.

Why is this the case? Since the Global Financial Crisis banks are now required to hold more capital and have higher liquidity levels. They are far better placed to weather the storm this time around than they were pre-GFC. Their ability to fund themselves is much better as well. The term funding facility has provided a large funding source for ADIs, reducing the amount of primary market issuance in the Australian market. This is Economics 101. If demand remains at the same level and supply is reduced you have to pay more. In the case of credit investors this higher price comes in the form of tighter credit spreads. Of course credit investors could substitute out of ADIs and into other sectors such as airports or utilities. These issuers don't have the luxury of a term funding facility and nor should they. As the following graph shows, the spreads on these issuers have behaved more in the manner that would be expected when economic growth contracts sharply:

Chart 2.  
Non-financial credit spreads



To maintain performance investors will need to look at switching out of lower-yielding bank debt and into less liquid, lower-rated corporate debt. The risks speak for itself although credit spreads may contract due to the increased demand.

What are the longer-term consequences of the Term Funding Facility? In the near term banks can replace more costly debt – both international and domestic – with the TFF. This is completely logical. What happens though, if rather than allocating to other credit issuers, investors move to other asset classes such as property, equity or emerging markets – instead of lower and lower yielding debt? If the TFF is extended further, this risk increases because it makes it more difficult for credit investors to invest cash from maturing securities that aren't replaced, in turn lowering returns. Reinvestment risk due to the TFF has increased. The main issuers of bank debt in the Australian market – the domestic banks – will need to come back to the market when the TFF is no longer available to them. Will the investor base still be there in the same size? Or will they need to pay a higher price (ie a higher credit spread) to attract investors from other asset classes? Rightly, the RBA has bigger concerns than this at the moment. It will be interesting to see how this develops.

# ESG

## Growing Importance of Fixed Income Engagement



Murray Ackman  
Credit/ESG Analyst



### Engagement in fixed income

How can fixed income investors nudge businesses towards a more sustainable future?

Equity owners can engage with shareholder resolutions, voting and executive-level meetings. But fixed income investors don't have the same levers.

We hold debt. We don't own any part of the business. Active ownership of bonds is about managing the risk of default rather than the potential influence a part-owner of a business might have.

Although we have fewer direct avenues to shape businesses, we take our engagement responsibilities very seriously and use the influence we do have.

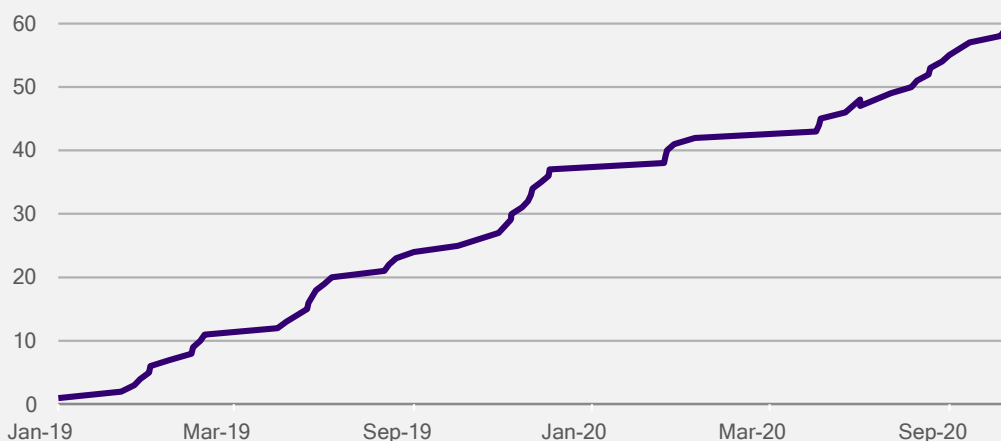
Fixed income investors engage on Environmental, Social and Governance (ESG) issues for much the same reasons as equity investors: to understand disclosure, influence the response to risks and opportunities for change and ensure positive ESG outcomes.

Pendal's Bond, Income and Defensive Strategies team strives to ensure investments bring about impact and help transition us to a better world. We also shape new types of investment instruments, providing feedback to issuers and managers on green, social, sustainable and sustainability-linked bonds. We might not get the headlines, but we try to influence wherever we operate.

### How are we engaging?

We've had 60 formal ESG engagements since 2019. These range from conversations about specific ESG concerns on the environment, worker safety and other challenges, to our expectations about the use of proceeds, impact reporting and even site visits.

Number of ESG engagements by BIDS (cumulative)



Source: Pendal

These discussions have ranged from the coal face all the way to executive level. We've found issuers are increasingly literate on ESG matters and we've seen them act on frank advice.

As we've increased the number and depth of engagements, we've found issuers and banks begin to come to us directly. Pendal portfolio manager George Bishay has recently spoken at several forums, providing insights on how to maximise impact using different funding instruments. He is not shy in sharing disappointment on perceived "green-washing" attempts or lower-than-expected impact levels.

Working with Regnan, Pendal Group's ESG research team, we are synergising conversations with businesses across asset classes. We've already seen an impact and we are further developing our capacity for engagement. We aim to continue as market leaders in ESG engagement for fixed income and further influence our space to make sustainability and impact the norm.

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

**PENDAL**

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