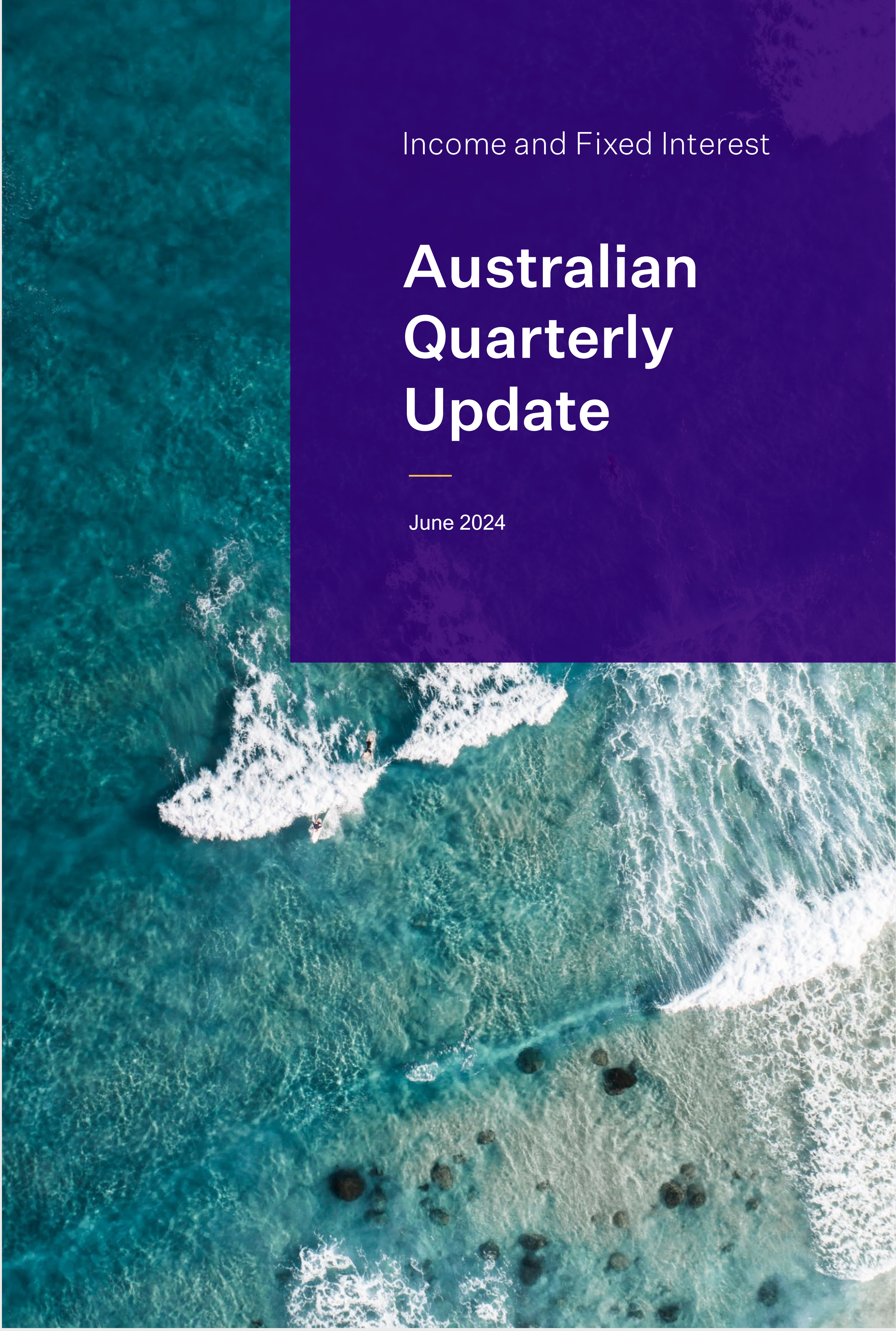


Income and Fixed Interest

Australian Quarterly Update

June 2024

PENDAL

Liquidity…are you prepared?

A guide to help you think about and plan your fund's liquidity

Tim Hext
Head of Government Bond Strategies

GENERALLY this quarterly article takes a deep dive into the economy.

In the past I've covered the inflation and employment outlook and will update these next quarter. I think the near-term data will be mixed before lower inflation outcomes hit in Q3.

This quarter I'm taking the opportunity to write about liquidity and how to assess it.

But let me begin with a story from the natural world which has lessons for liquidity and the economy.

Sequoia trees and fire

In the beautiful national parks of the western United States stand giant redwood and sequoia trees, often soaring towards 100 metres high. Some of them date back a thousand years or more.

For centuries, nature maintained an environment for these trees to survive and thrive through periodic, naturally occurring, large (but not catastrophic) forest fires every five to 35 years.

The fires were big enough to reduce undergrowth without destroying the giant sequoias. This produced ideal conditions for young sequoias to emerge and grow. Low-level fire was needed to release seeds from their pine cones. Nature had found or evolved to a balance.

Enter well-meaning but ignorant westerners in the late 1800s.

Not only were large tracts of land cleared, but new national parks were created. Rangers made sure they tried to supress any emerging fires – since fire was considered bad. This meant a massive build-up of undergrowth into the 20th century.

As a result, when long dry spells hit, the fires that did eventually break out were far more catastrophic. Giant sequoias that had survived centuries of fires were destroyed. The central California Castle Fire in late 2020 alone is estimated to have killed 10 per cent of the world's giant sequoias.

Perhaps you can see the analogy here for markets.

Even though we may not want periodic credit crises or economic slowdowns, in a normal economy they should happen. We need to let weak businesses fail, otherwise the system will continue to build up more fuel for a massive credit crisis later on down the track. Central banks and governments must be careful to allow this to happen by not taking on credit risk from the private sector during a crisis.

However, while the weak must be allowed to fail, central banks and governments need to make sure the system itself remains strong at the core. This was one of the lessons from the GFC. Australian banks now have highly implicit protection from the RBA, the quid pro quo being that they are now highly controlled and regulated by APRA. The next crisis will not have banks at the centre, but rather the rapidly expanding world of unregulated finance – whether it be private markets, hedge funds or asset managers.

So, what is this highly implicit protection that banks receive from the RBA?

Banks always have access to “ample liquidity”, but especially during a crisis. The RBA is not taking the credit risk off them (though the US Fed and ECB seem to have less of a problem doing this), but rather ensuring that sound assets can be financed at a time no one else is providing liquidity.

This paper describes the liquidity system the RBA provides. It also encourages asset owners to think about their own liquidity and how they too can interact with this ample liquidity.

If the dark days and near misses of the pandemic chaos of March 2020 are any guide, there is still much work to be done by many.

What is liquidity?

The definition is very straightforward: how quickly and easily an asset can be converted into cash. This could be by sale or by using the asset as security for a cash loan.

Of course, the next question to ask is, under what market conditions?

In normal markets, liquidity is good for most public assets. Yet, liquidity is not usually called upon in normal times but rather in stressed times. The need to sell bonds to raise cash, to meet redemptions or, perhaps, to buy equities is likely to come in major risk-off events. March 2020 is a case in point I will refer to many times in the piece.

Therefore, I will not discuss “normal” liquidity but rather focus on stressed market liquidity when analysing liquidity.

I am happy to discuss bid/offer spreads and how much of an asset can be transacted in normal times with any investors interested.

Understanding the Australian financial system liquidity framework.

1. Daily banking system - RBA real time gross settlement

The RBA is at the centre of the liquidity framework.

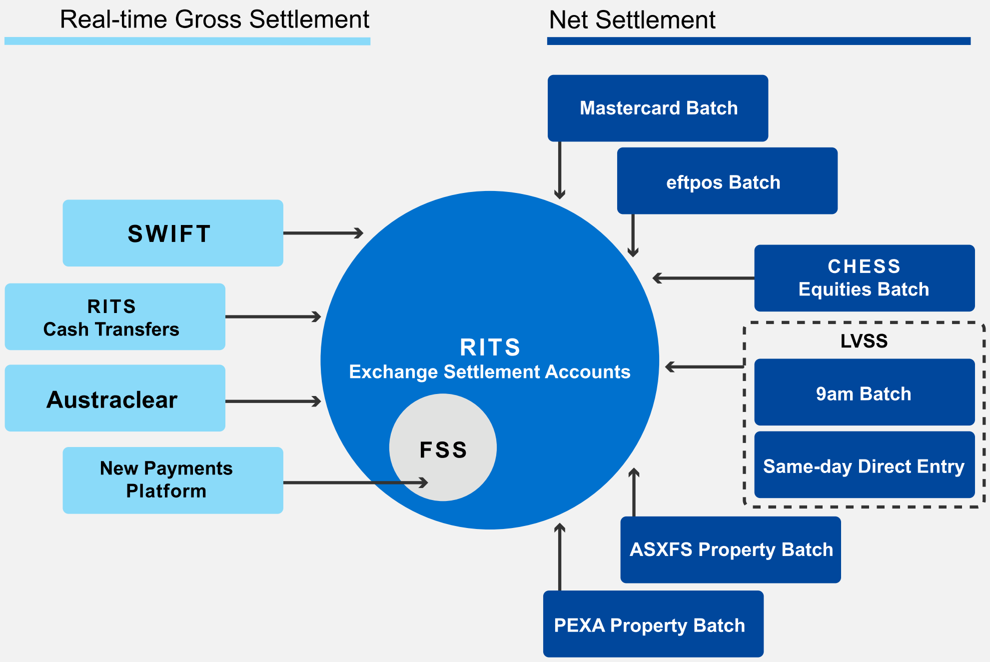
That is because it has a superpower that no one else in the economy has - it can create money.

Banks can create credit which, in turn, increases money supply. But they cannot create money.

The RBA uses its superpower in three ways in the banking system to ensure smooth operation and liquidity.

Chart 1.

Interbank settlement in 2022



Source: https://www.rba.gov.au/publications/bulletin/2022/mar/the-evolution-of-interbank-settlement-in-australia.html

Note: FSS is the Fast Settlement Service which is now 24 hours and expands real time settlement to low-value retail payments.

2. Banker to the federal government

The RBA is banker to the federal government.

When the government transacts on its account at the RBA, it creates a surplus (think welfare payments) or deficit (think tax payments) in the private banking system. In order to balance the system, the RBA would then either add or drain money via open market operations (OMOs). This has not been required since the massive increases in excess reserves (ES balances) from QE in 2020 and 2021, where the RBA created money that stayed in the system.

The RBA is now proposing a new system of “ample liquidity” to replace the corridor system of implementing monetary policy. Open market operations will offer ample liquidity (limited only by collateral) at a fixed price. ES balances will get smaller over time as QE runs off. Banks will be able to add to balances via ample liquidity. Given there is a cost (borrowing at likely cash plus five basis points and lending back to the RBA at cash less 10 basis points), banks will still limit how much excess they run.

As a side note, if the Federal Government spends more than it drains in taxes - a budget deficit – it usually drains the excess spending by issuing bonds (through the AOFM).

However, through its superpower, the RBA could allow the government account to go negative at any time it wants by creating the money and giving/lending it directly to the government. For the RBA, the offsetting item will be the increase in ES balances as the private sector now has a surplus that goes back to the RBA. In other words, issuing bonds is a conscious government choice but not a necessity in implementing expansionary fiscal policy.

If anyone is interested in further reading on this please ask your Pendal account manager for my paper explaining Modern Monetary Theory in 2020.

3. Injecting liquidity in a crisis

The banking system described in the first section relies on every bank being happy to take the credit of other banks as they net off their surplus or deficit within the system. The private sector is always in balance, as for every credit there is a debit, for every asset a liability.

However, this does rely on trust – something which disappears quickly in a crisis. Banks with a surplus in the private system may not want to take the credit of banks with a deficit. They will, therefore, deposit the surplus funds at the RBA, not worried about the lower return. This leaves other banks in the private system short of funds. In turn, they must go to the RBA to access these funds.

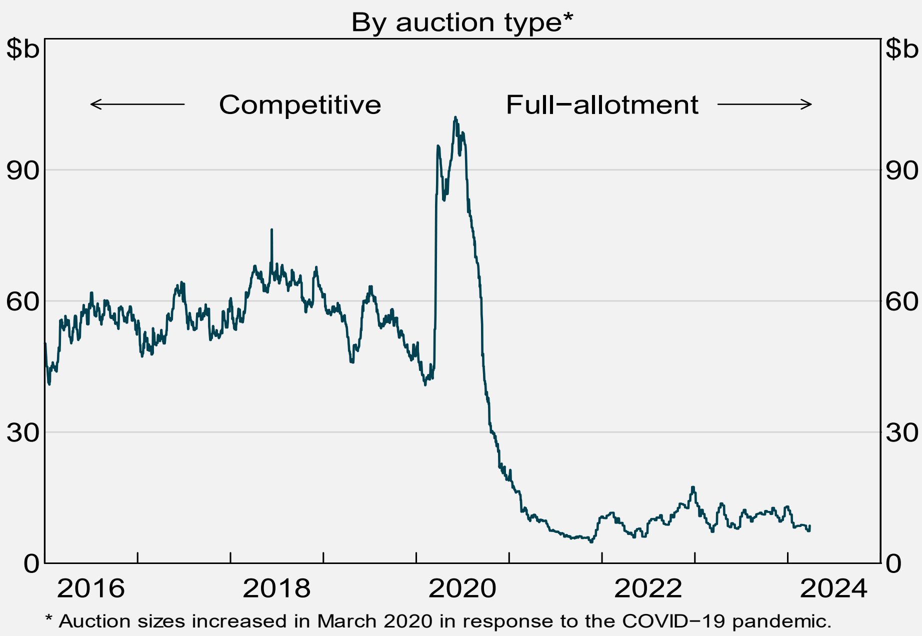
Under the corridor system, the RBA would always offer funds at 25 basis points over the target cash rate (and would take funds at 25 basis points under). However, banks would do everything they could to avoid tapping these funds – not just because of the higher interest rate, but mainly due to the stigma that it involved. If other participants found out your credit lines were being pulled around town, it could lead to further trouble.

This breakdown in trust, as evidenced in March 2020, meant the RBA would seek to flush the market with funds by offering large amounts of OMOs. Banks caught short of funds could use their HQLA to borrow money from the RBA, who would create it. This extra money would mean ES balances would net rise in the system as again, the new money created is surplus to the private system – merely a result of non-netting due to a lack of trust.

This is shown in the sharp rise in OMOs in March 2020. Note also the sharper fall in OMOs after QE (the Term Funding Facility and, later on, RBA bond buying) massively boosted ES balances, reducing the need for any OMOs.

Chart 2.

RBA OMO outstanding



Source: RBA

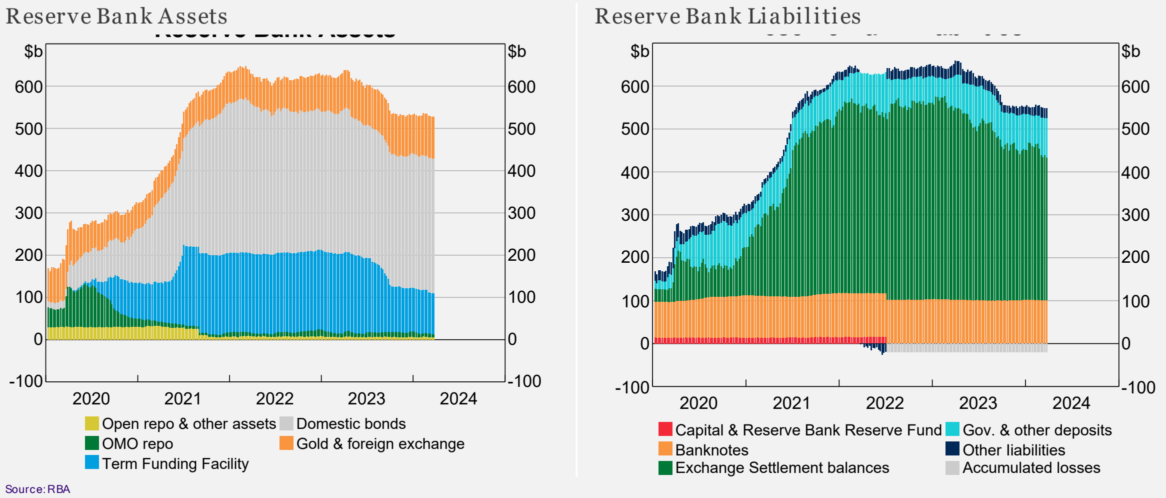
The proposed move to a new regime of "ample liquidity" would be slow to be tapped as despite the TFF ending, the RBA still has massive holdings of government bonds that create large-scale excess reserves. These will take another eight years to fully unwind.

The RBA balance sheet below shows how these continue to dominate that balance sheet. If they were to begin some quantitative tightening through bond sales rather than maturities, it would decline more quickly.

Chart 3.

RBA balance sheet run-off

Extraordinary policy slowing running off



Source: RBA

Tapping into the liquidity system

The question for investors when thinking about their liquidity in a crisis is how they can tap into the liquidity system.

As most of us are not participants in RTGS, we rely on intermediaries, the banks, to reflect their liquidity to us. The system has been set up for banks, which usually have short-term liquid liabilities (think cash accounts) and long-term illiquid assets (think home loans), leaving them exposed to bank runs. This is why they carry HQLA, which can act as collateral with the RBA or even be sold down.

In a crisis like March 2020 very few instruments stay liquid. Not surprising the instruments that did stay liquid had the RBA implicitly behind them.

Cash accounts stay liquid. So do bank bills and bank certificates of deposit (NCDs). This is because bank treasury teams can tap into the RBA for funds.

Government bonds stay liquid for the same reason. Banks can use them as collateral for OMOs. Also, bank treasury teams can hedge them with futures to reduce value-at-risk (VaR) calculations, which also act as a constraint in a crisis as volatility spikes.

Beyond this suite of products, liquidity dried up very quickly in March 2020. Bank FRNs are term funding and in a crisis, bank treasury teams can ill afford to reduce term funding by buying them back. Their liquidity becomes challenged very quickly. This is problematic for many Australian funds that happily pick up the extra accrual a bank FRN offers over a bank bill, but too often rely on them for liquidity in their funds.

We experienced this firsthand in March 2020 when banks were able to buy back large volumes of NCDs from cash funds like ours. However, when we asked for bids in FRNs, they were very wide and only in small volumes as bank trading desks, not treasuries, were having to bid on them. These were senior FRNs. For Tier 2 bank debt, the market effectively closed.

Supranational bonds and other corporate bond liquidity almost completely dried up and could be best described a ‘bid on appointment’ – trading desks would take your sell interest to their investors hoping to find a buyer on your behalf. The RBA did step in and widen eligible collateral to include investment-grade corporate debt in late March 2020, but stopped short of buying the debt.

Of course, the other instrument that remained liquid was equities, though smaller names were challenged. This shows the benefit of having an exchange-traded asset with a wide breadth of participants – you may not like the price, but someone will show you a bid.

I assume holders of term deposits are very clear these days on the lack of liquidity before maturity. Likewise, anyone investing in sub-investment-grade credit or private debt should have very low expectations of liquidity even in the good times, so presumably will not be relying on them for liquidity in a crisis.

Where does the need for liquidity arise?

The banks need for liquidity is clear. However, for any fund that offers liquidity there needs to be careful modelling done around liquidity. Funds also need to be clear on what representations they make around liquidity in all market conditions.

Industry super funds, like other funds, are always open to the risk of members switching funds. However, due to the passive nature of most members and the inability of members to withdraw super pre-retirement, there is little chance of a run on their funds in a crisis. They often rely on what are generally net inflows to hold less liquidity than their vulnerability to members withdrawing funds.

In March 2020, though, two events took place that challenged the generally complacent management of liquidity in these funds. The first was the government's policy decision in 2020 to allow eligible members to exercise the early withdrawal of up to $20,000 in super. About $35 billion in total was withdrawn.

The second less publicised event was the initial collapse of the AUD in March 2020. In two weeks, it fell from $0.66 to $0.58 – a drop of 12%. What is not widely appreciated is the impact this sudden move had on FX-hedged offshore investments. A much larger amount of AUD was required to support the same amount of USD. This happens through collateral calls for cross-currency swaps or the rolling of FX forwards.

Australian super funds now have almost half of funds invested offshore. The RBA estimates 30% of this is currency hedged. Based off an estimated super system balance of $3 billion in 2020, this equates to $450 billion of currency hedging. A fall of 12% in the currency means around $50 billion of liquid collateral must be posted. That number would be higher today.

Overall, a sudden collapse of the AUD actually injects money into our system, as banks who borrow offshore and swap back to Australian dollars see huge collateral inflows. However, super funds need to raise liquidity as they are going the other way. Much like the government-driven early redemptions, the speed and size of this shock put significant strain on the liquidity of a number of small and large super funds.

The final need for liquidity is simply the freedom to make rational asset allocation decisions to take advantage of price dislocations in a crisis.

As a government bond manager, the irony in 2020 was that it was because – not despite of – my asset class performing the best and being the most liquid that I saw large redemptions.

Not all holders wanted to sell their government bonds but were forced to given it was, along with cash and NCDs, the only liquid asset class. Some of this was being rightly allocated to equities, but much of it was simply to meet redemptions and collateral calls.

How can funds make sure they are liquid?

One claim I hear from many funds is that they never had to gate their funds in March 2020. This is because it was largely not tested due to the quick measures taken by the government and the RBA. The nature of the crisis – randomly impacting everyone – meant there was a lot of goodwill in these measures. Unlike in 2008, no one was playing the blame game – at least not in finance.

However, your more standard economic crisis should see a more standard liquidity crisis where those not prepared would need to gate their funds. Also, there is always individual name risk for any fund – large or small – where the public rightly or wrongly perceives their money at risk and tries to withdraw it.

That means funds must have a liquidity plan in place for the so-called rainy day. Banks, regulated by APRA, spend much time and resources doing this and even have ratios they are required to meet. The Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) were brought in post-GFC as part of Basel3. The superannuation system has now grown in size and its importance is almost as crucial to Australia's economic future as the banking system – yet there are currently no similar requirements for super funds. Some funds now actively boast about their large holdings of illiquid private assets.

APRA did release a paper in 2020 discussing super fund liquidity through the pandemic crisis: Managing super fund liquidity in the midst of COVID-19 | APRA

Funds are required to have a Liquidity Management Plan and are supposed to stress test their liquidity. APRA is supposed to monitor this, but it is not prescriptive like it is for banks. There is a Prudential Standard SPG 530, which was updated in July 2023, but the *two whole pages* on liquidity (yes, that is sarcasm) is big on concepts but very light on any detail – acknowledging that many liquidity plans "include minimal detail on roles and responsibilities, liquidity risk tolerance and actions that should be taken following a liquidity event". It took two banking crises (1992 and 2008) before banks were whipped into shape as "unquestionably strong".

Let's hope history does not repeat itself.

Conclusion

Investors need to honestly appraise the liquidity of their funds.

The RBA, through the ability to create money, sits at the centre of the liquidity system. Investors should make sure that this support is reflected in the instruments that they rely on for liquidity.

This paper outlined what those instruments are and how the system works. If investors rely on investments in funds for their liquidity, make sure that by chasing the marginal extra return that they haven't drifted outside the guardrails. Ask you manager about liquidity in a crisis, not in normal times.

Investors must view liquidity as a necessary cost. Yes, cash and government bonds offer relatively low returns, but investors should view that opportunity cost as the liquidity insurance premium they are paying. Like insurance, there may be a day when you come to claim, as governments won't always be there to save everything. Like the giant redwoods and sequoias of California, make sure you are not the undergrowth that is allowed to burn.

What type of landing do income funds like?

Amy Xie Patrick
Head of
Income Strategies

Is your income fund one-dimensional?

THE answer to this question depends on what kind of income fund we're talking about.

Income funds that target returns of around 2% above the RBA Cash Rate tend to be powered by the safest and least volatile income-generating assets: floating rate investment-grade corporate bonds. It certainly forms the core income engine within Pendal's income strategies.

Unfortunately, the average spread of investment-grade credit in Australia is…not much. At the time of writing, the average credit spread of bonds in the AusBond credit FRN index is well under 1%.

The next easiest thing to do is to reach for higher-yielding credit. This can be done by extending further out along the maturity curve, further down in ratings (quality), or a combination of both.

It's easy because *a lot of the time* credit spreads are not very volatile. Certainly when compared to the volatility of government bonds or equities.

It's also easy because *when the economic environment is benign*, credit spreads tend to narrow. That narrowing of spreads results in higher prices on those corporate bonds and mark-to-market gains for the portfolios that hold them.

The result, however, is a one-dimensional portfolio. Fine for the good times, but unable to properly respond when the going gets tough. That's why Pendal's income strategies won't stray into assets of lower quality or questionable liquidity. Instead, we build in different levers for both the good and the tough times.

Figure 1.

Horses for courses

Different environments call for different asset mixes

	Rates are low	Rates are high
Volatility is low	Soft landing Floating-rate credit Equities / risky assets	No landing Fixed/floating-rate credit Equities / risky assets
Volatility is high	Hard landing Govt. bonds Fixed-rate credit (high quality IG only)	Stagflation Cash Floating-rate credit (high quality IG only)

Yes to credit; no to illiquidity

Credit-heavy income funds like soft landings – the top-left quadrant of Figure 1. They also like no landings as long as it doesn't come with renewed inflation fears that jeopardise the performance of risky assets. That's the top-right quadrant. In both of these "landings" low market volatility is a pre-requisite. In other words, credit-heavy income funds do well in the good times.

Yet for a lot of investors we speak to, income funds are used as a pillar of stability and even defensiveness within their overall portfolios. They don't like to miss out on good returns in the good times, but they demand the agility to change tack when the going gets tough. A credit-only portfolio that has sacrificed quality and liquidity to make the most of the good times will lack that agility in the bad times.

Currently in Australia, the market thinks we're heading for the top-left quadrant: a soft landing. In the US, however, the market is divided between the top two quadrants. In the event of no landing, the likelihood of falling into the bottom two quadrants in 2025 will be much higher.

Both a hard landing and stagflation are bad outcomes for risky assets. Australian credit will follow where US credit markets go. 2022 was a year of stagflation. Growth slowed and inflation accelerated. If that were to repeat, cash would be king once more, but rates will offer opportunities along the way. That's because yields are substantially higher today than in 2022.

A hard landing or stagflation will require income funds to be able to move quickly up the quality ladder in their credit exposures. This is very difficult to achieve if the starting position is in poorer quality and lower liquidity issuers or structures. Since these shifts can occur very suddenly in markets, Pendal's income strategies choose to stick with higher quality credit exposures as a matter of course.

To keep up with the pack in the good times, our strategies position in other asset classes such as equities and emerging markets in very liquid ways so we can turn off those exposures as soon as we believe things are souring.

To manage the downside in hard landings or even stagflation, our strategies actively utilise a large range for interest rate exposures.

Which landing is most likely?

So what kind of landing might be good for Pendal's income funds?

Like all income funds, any landing where volatility can stay subdued is welcome news. Unlike most floating-rate credit funds, ours can add duration as an extra source of income and returns in these scenarios. Also unlike most credit-heavy income funds, our strategies won't need to sacrifice on quality or liquidity when chasing higher returns in benign environments.

This last point is crucial when it comes to landings that are accompanied by higher volatility. De-risking our income strategies when we anticipate market stress involves something as simple as selling futures on the ASX. Then depending on the inflationary backdrop, we can judge whether adding interest rate exposures would be helpful.

… continued

The first quarter of 2024 has been largely benign.

Rate cut expectations have been dialled back because economic resilience has been maintained. Our income funds held on to their strong performance of 2023 and added a margin of between 0.3-0.5% above cash over this period.

This has been achieved while maintaining high-quality credit exposures and being very selective about taking interest rate exposures. The lower hanging fruit for most of the first quarter was in riskier assets.

The opportunity set will change as we move through the rest of 2024. Despite some hiccups in recent data, wage and price inflation will likely cool further.

Labour markets will loosen and unemployment has already been creeping higher. We hope for a soft landing, but think we need to be prepared for a harder landing.

The important thing is that our income strategies have tools to manage both.

Buyer's market to seller's market in credit

A shift in the bond issuance landscape

Terry Yuan
Senior Credit Analyst

THE credit bond issuance market has undergone a marked transformation in recent months, shifting from a buyer's market to a seller's market. This unprecedented shift has led to significant changes in pricing dynamics.

Issuers now hold greater power to dictate pricing.

Shifting power dynamics in the bond market

For many years, new credit bond issuers typically offered new issuance concessions (NIC) in the form of basis points (bps) to entice buyers.

Buyers of credit are a diverse crowd, including asset managers, superannuation/pension funds, insurance companies, banks, Asian hedge funds, and even private wealth clients. NIC were historically in the low single digits, but recently, strong investor demand – particularly from superannuation funds and Asian investors – has compressed NIC down to zero and even negative territory.

This surge in investor demand has fundamentally shifted the power dynamic.

Focus on headline yields

In this high-interest rate environment, some foreign investors are focusing solely on headline yields and not credit spreads to the risk-free rate or swap rate. Instead of assessing if credit spreads are commensurate with the credit risk, these investors are happy to lock in these higher yields for as long as possible. As a result, their primary concern is whether the total yield exceeds a threshold – for example, 6% total yield.

Oversubscribed deals and issuer advantage

Consequently, we're seeing a significant number of deals become heavily oversubscribed, meaning there's more investor appetite than the issuer's borrowing needs. This allows issuers to aggressively tighten pricing by three to four times more than historical tightening. Many times, issuers are offering bonds at yields lower than those currently priced in the secondary market, which has previously been rare.

Traditionally, not offering a new issuance concession was a risky move for issuers. But the current market suggests some large investors are less concerned about price and are willing to buy bonds even if they're more expensive than existing similar bonds.

Investor reluctance

This trend is evident in recent deals where pricing has tightened by a staggering 20bps from initial guidance to final pricing.

Historically, such tightening has been a much smaller 5-10bps, at most. Such dramatic tightening can be off-putting for many rational investors. In a recent deal with a 20bps price tightening from initial price guidance, nearly 40% of investors withdrew their bids. This reluctance highlights investor concerns that tighter pricing doesn't offer enough credit spread to compensate for the underlying credit risk.

Despite a significant number of investors withdrawing their bids, recent deals have still been heavily oversubscribed. This means that issuers were still able to raise the capital they needed, and at very attractive borrowing levels.

Selective investment strategy

As we navigate this evolving economic and market cycle, our commitment remains the same: to deliver consistent returns through any market condition.

This means avoiding market hype and focusing solely on the best deals – those offering the most attractive spreads relative to the inherent risk. We believe this disciplined approach will continue to serve investors well in the years to come.

Confused about ESG?

Get up to speed in five minutes

Murray Ackman
Credit/ESG Analyst

MANY large funds now have ESG (environmental, social and governance) specialists, like me, who are immersed in that world.

Beyond these people, most investment professionals are not involved in the world of ESG on a regular basis. This means sometimes it can all be a bit confusing.

Unsurprisingly for an area named after an acronym, it is jargon-filled and requires an understanding of different regulations, methodologies and taxonomies. Here is a quick update for time-poor investors to help clear up some of the confusion.

Much of the confusion about ESG stems from three areas:

1. Are we looking at the same thing?

Unlike balance sheets, the numbers for ESG require more interpretation.

Third-party ESG data providers have different views and methodologies for rating different companies. While credit rating agencies can have different ratings, they largely look at the same data to do this (i.e. audited financial statements). In contrast, ESG can include absolutely everything that has an impact on the macro, meso and micro ESG risks a company may face.

Some are also confused about what an ESG rating is. It is not about the industry they are in. This means if a particular fossil fuel extraction company is managing their ESG risks well they can get a good ESG rating. If investors don't want to invest in fossil fuels, that is a separate issue and not the aim of ESG ratings. That is what negative screens are for.

2. Are you saying what I think you're saying?

It's hard to go anywhere without seeing advertisements about how if you invest your money with a particular fund, you'll be able to save the world. Regulators and gatekeepers have stepped in to ensure there isn't so much noise to prevent misleading and deceptive conduct – including education for clients, longer caveats and trying to have more defined terms (such as what sustainable means). For investors, this means more surveys, greater reporting, focus on data, and ensuring proper systems are in place.

Consistency in terms and data so people can actually understand what is being said is a very positive step. The regulators are helping with this, pushing for language that people understand to encourage movement to sustainable investments. But it's still wonky. The focus on education, greater disclosure and reporting can result in more reports that are read by few and a greater onus on the buyer/client. I don't want to read every food label to know what is good for me.

The big role of ESG in the investment process is to provide more information to make investment decisions.

3. Does ESG actually affect investment decisions?

You should be able to find ESG integration statements on most large asset managers' websites, which outlines how they include ESG considerations in their decision-making.

Sometimes this could be more of a token and sometimes the ESG considerations can have only a very limited influence in an investment decision. However, this differs across asset classes. Limiting exposure to energy companies which rebounded with the Ukraine/Russia war would've made outperformance difficult for equities, but it had very little impact on fixed income.

How much ESG is included in decision-making is ultimately up to clients: do you want to invest to make a more sustainable economy and potentially avoid some risks, or is performance the only thing that matters to you? At the end of the day, fund managers, superfunds and financial planners are all trying to serve the needs of their clients.

These three areas of confusion are the growing pains of a relatively new field. It all just depends on the outcomes you are looking for.

The key questions to ask

I have five questions that help address how deep into ESG investing you might want to go (and what the ESG label for this is):

- Do you want funds that consider ESG risks or opportunities when making decisions? **(ESG integration)**
- Do you want to avoid certain sectors? **(negative screens)**
- Do you want funds that are making sure companies and issuers are managing their risks? **(engagement)**
- Do you want funds that have a positive tilt with a process for selecting investments? **(sustainable)**
- Do you want funds that are making a positive impact with real world outcomes? **(impact measurements)**

Ultimately, most of what makes ESG scary is because it's a new topic full of new words. As ESG continues to normalise, as regulators outline the expectations, and as clients become more aware of the lingo, some of this confusion should fade.

For more information call us on 1300 346 821
or visit **pendalgroup.com**