

Australian fixed income monthly (September 2020)

12 October 2020

By Darren Langer, Head of Australian Fixed Income

Australian market commentary

The Australian bond market (as measured by the Bloomberg AusBond Composite 0+ Yr Index) returned 1.08% over the month. The yield curve flattened as 3-year government bond yields ended the month 10 basis points (bps) lower at 0.16% while 10-year government bond yields fell 19 bps to 0.79%. Short-term bank bill rates were largely steady. The 1-month and 3-month rates were both unchanged at 0.09%, while the 6-month rate was 3 bps lower at 0.12%. The Australian dollar was weaker, closing the month at USD 0.71.

The Reserve Bank of Australia (RBA) reaffirmed its commitment to support the financial system through a historically low cash rate of 0.25% and yield curve control to keep 3-year bonds at 0.25%. The RBA's Term Funding Facility has been extended in both size and duration. These measures are intended to keep funding costs low and sustain credit availability.

Domestic economic data releases were mixed in September. Employment rose by 111,000 positions in August, exceeding market expectations. The unemployment rate declined to 6.8%, which was also better than expected. Q2 GDP slumped -7.0%, sending Australia into its first recession since 1991. The NAB Survey of Business Conditions fell in August to -6 points, with business confidence remaining weak at -8. Retail sales were up 3.2% in July. National CoreLogic dwelling prices continued to fall in September, ending the month down 0.1%.

Australian market outlook

The outlook for both the Australian and global economies continues to be clouded by the COVID-19 crisis. Despite the severe contraction in Q2 GDP which has seen Australia enter a recession, the downturn is not as severe as previously expected and a recovery (albeit a patchy one) appears to be under way.

The Australian government introduced unprecedented stimulus measures to overcome the crisis, and questions still remain over what will happen when these initiatives end. While a number of measures, e.g. JobKeeper and JobSeeker, have been extended to March 2021, these are at reduced rates. The Australian Federal Budget was released on 6 October, with increased spending and tax cuts to aid the economy as it recovers. Many countries across the globe will be running deficits of over 10% of GDP. The Australian government is no different and it will need to fund large levels of debt issuance this year, with AUD 214 billion of financing required (11% of GDP).

The RBA's quantitative easing (QE) has been designed to make financing conditions easier and to give banks an incentive to make sure the money gets to where it is needed most. While over the past few weeks the RBA has begun signalling that it could conduct additional unconventional monetary policy if required, they have not yet indicated what that would look like or when it could come. Given the weakness in the economy we expect

additional easing to come sooner rather than later, with the cash rate cut to 0.10% and additional bond purchases made.

According to APRA, loan deferrals totalled AUD 229 billion, or approximately 8.5% of total loans outstanding (as at 31 August 2020). The majority of the deferrals by dollar value (almost 70%) are housing loans; however, the incidence of deferrals is higher in business loans (16.2%) than it is for housing (9.0%). APRA expects lenders to encourage borrowers that can restart repayments to do so, and to identify, monitor and manage any loans where this is not possible. This appears to be happening, as exits from deferral continued to outweigh new entries for the second straight month.

Credit commentary

After four months of strong performance the credit markets retraced their gains made in August. But they are still close to pre-pandemic levels, although a few of the most challenged sectors remain at elevated spreads. Domestically, physical spreads to government widened about 10 bps while in synthetic markets the US CDX widened by 11bps, the European iTraxx by 6 bps and the Australian iTraxx by 2 bps.

Banks seem to have mostly drawn down their entitlements under the Term Funding Facility (TFF) initial allowance just before the 23 September deadline. The high level of liquidity and the relative lack of lending opportunities meant that banks tended to wait until the available time was nearly over. The TFF will result in issuance of senior bank debt and securitisation being very limited over the next one to two years. The perception that the Committed Liquidity Fund (CLF) would become more restricted in light of the TFF seems to have been premature given recent comments by the RBA about self-securitisation.

In other banking news, further encouragement for bank lending beyond the liquidity from the TFF is being given by the Commonwealth government through changes to responsible lending rules that lighten the assessment burden for banks. The Commonwealth Bank revealed that home loan repayment deferrals on its lending book declined to AUD 45 billion in August, down slightly from AUD 49 billion in June. APRA's data indicated AUD 229 billion worth of loans in Australia (home, business and personal) were still on temporary repayment deferrals, accounting for around 8.5% of total loans outstanding in Australia. Westpac agreed to pay the largest fine in Australian corporate history—an AUD 1.3 billion civil penalty for more than 23 million breaches of anti-money laundering laws.

The Reserve Bank of New Zealand (RBNZ) released a report on bank capital running its test of two key scenarios, a pessimistic baseline scenario (PBS) and a very severe scenario (VSS). While banks remained above their regulatory minimums under the PBS, they were breached under the VSS. It remains to see to what extent and in what manner the RBNZ will require banks to increase their capital.

In ratings news, Coca-Cola Amatil Ltd had its BBB+ Standard & Poor's (S&P) rating withdrawn at its request. MyState Bank was downgraded to Baa2 from Baa1. Snowy Hydro Ltd was downgraded to BBB+ from A- by S&P. Lendlease had its outlook revised to stable from negative by Moody's following the completion of the sale of its engineering business, AMP and AMP Group Holdings were downgraded to BBB- from BBB by S&P and AMP Bank was downgraded to BBB from BBB+. Australia Pacific Airports (Melbourne Airport) was downgraded to Baa1 from A3 by Moody's, with the cut bringing it into line with S&P's rating of BBB+. Fitch affirmed Adani Abbot Point Terminal at BB+ and moved it from Ratings Watch Negative to a stable outlook. The outlook on Wells Fargo & Co was revised to negative from stable.

Fitch took ratings actions on French, Dutch, Scandinavian and Singaporean banks. The actions included moving Credit Agricole to negative outlook from stable and placing BNP Paribas, Group BPCE and Societe Generale to Rating Watch Negative. ING was moved from Ratings Watch Negative to negative outlook. Rabobank was downgraded to A+ from AA- and ABN Amro was downgraded to A from A+; both are still on negative outlook. Nordea Bank and Svenska Handelsbanken were moved from Ratings Watch Negative to negative outlook. The ratings for DBS, Overseas-Chinese Banking Corp and United Overseas Bank were all reaffirmed at AA- and removed from Rating Watch Negative but negative outlooks were retained.

S&P released updated default statistics. There were 88 rated defaults in the quarter, up from 30 in both of the previous two quarters. This is the second highest number of defaults in a single quarter in S&P's rated universe, behind only 1Q 2009 when 101 defaults were recorded. The US region made up 57 of the defaults, while on a sector basis, the consumer/services sector recorded the highest number of defaults (24), followed by the energy and natural resources sector (23). The global second quarter default rate increased to 1.23% from 0.42% in the previous quarter. S&P's global trailing three-month speculative grade default rate almost tripled to 2.44% at the end of the

quarter, driven by US and European default rates, which increased to 3.05% (from 1.07%) and 1.66% (from 0.56%), respectively.

There were 14 corporate issues in September for a total of AUD 5.84 billion, with non-financials (including Qantas, SGSP Australia, PACCAR, NSW Electricity and AusNet) making up just over AUD 2.7 billion of that amount. Financial issuance consisted of two subordinated capital-related deals (CBA and DBS) with a few offshore issuers (Kiwibank, Shinhan Bank and Bank of Communications) also accessing the market. Although supply of corporate paper has been steady for most of this year (apart from March), the total issued is about AUD 19 billion lower than the comparable period last year. After a quiet August, issuance in the securitised market was very strong in September with nine issues totalling AUD 5.55 billion. This comprised three non-conforming RMBS (Sapphire, RedZed and La Trobe), two non-ADI issues (Resimac and Mortgages House), two balance sheet issues from banks (HSBC's Lion Trust and AMP Bank's Progress) and two ABS (Liberty SME loans and Metro car loans).

Credit outlook

After a contraction of spreads over the last months, credit is less compelling than in March. The term of and response to the virus remain the core determinants of the outlook. With the current environment of uncertainty and nervousness as demonstrated by the resurgence of infections in Victoria and new waves of infections in both the US and Europe, caution becomes a key requirement. Understanding of the different risks involved in individual credit issuers has become increasingly pertinent as the initial broad-based spread widening becomes increasingly refined, depending upon the exposure of each issuer to the COVID-19-affected areas of the economy.

Both supply and demand are lower domestically than last year, but supply has been assisted by local non-financial issuers being more willing to access the domestic market. However, at least until the markets settle and outcomes from virus-related restrictions become clearer, supply will likely be uncertain, in our view. Domestic non-financial supply is traditionally less abundant and is being tempted to offshore markets where government buying of credit has strengthened both demand and pricing of credit.

We believe allocation to credit should be more weighted towards shorter-dated credit which is less sensitive to spread movements. Given that the TFF will dampen local financial supply as mentioned earlier, domestic banks are less likely to access the market. For offshore issuers, caution must be applied due both to the long running issue of the complexity of the variations in treatment of capital requirements with varying rules on TLAC (total loss-absorbing capacity) and the different levels of impact of COVID-19 in each of the markets.

Accordingly, although domestic banks offer a simpler value proposition, supply is uncertain and they are likely to become increasingly expensive. Hence, offshore financials are becoming an important part of the investment universe. On the non-financial side, airports and airlines are the most obvious sectors to avoid, but even the less immediately-exposed issuers must be scrutinised very carefully for indirect impact from the expected economic downturn. Securitised products would appear to be a potential area of value, but even with these a thorough examination of structure and assets is necessary and supply may be threatened by competition from the TFF.

Contact us

Nikko AM Limited

Level 26, One International Towers Sydney, 100 Barangaroo Avenue
Barangaroo NSW 2000, Australia

GPO Box 3881, Sydney NSW 2001, Australia

Phone: + 61 (0) 2 8072 6300

Fax: + 61 (0) 2 8072 6304

Email: enquiries.au@nikkoam.com

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (Nikko AM) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute personal investment advice or a personal recommendation and it does not consider in any way the objectives, financial situation or needs of any recipients. All recipients are recommended to consult with their independent tax, financial and legal advisers prior to any investment. This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this document will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice. In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual securities, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements. All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association.

United Kingdom and rest of Europe: This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the Financial Conduct Authority (the FCA) (FRN 122084). This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the FCA in the United Kingdom, and is directed at professional clients as defined in the FCA Handbook of Rules and Guidance.

United States: This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information to institutional investors as defined in the Securities and Futures Act (Chapter 289), and intermediaries only. Nikko Asset Management Asia Limited (Co. Reg. No. 198202562H) is regulated by the Monetary Authority of Singapore.

Hong Kong: This document is for information to professional investors as defined in the Securities and Futures Ordinance, and intermediaries only. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

Australia: This document is issued in Australia by Nikko AM Limited (ABN 99 003 376 252, AFSL 237563). It is for the use of wholesale clients, researchers, licensed financial advisers and their authorised representatives only.

New Zealand: This document is issued in New Zealand by Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562). It is for the use of wholesale clients, researchers, licensed financial advisers and their authorised representatives only.

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Holdings group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document neither constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree 80/98), nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article

139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request. The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.

Republic of Korea: This document is being provided for general information purposes only, and shall not, and under no circumstances is, to be construed as, an offering of financial investment products or services. Nikko AM is not making any representation with respect to the eligibility of any person to acquire any financial investment product or service. The offering and sale of any financial investment product is subject to the applicable regulations of the Republic of Korea. Any interests in a fund or collective investment scheme shall be sold after such fund is registered under the private placement registration regime in accordance with the applicable regulations of the Republic of Korea, and the offering of such registered fund shall be conducted only through a locally licensed distributor.