CPG
Research & Advisory Pty Ltd

Market Update:

Fixed Interest Analytics

January 2018

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Credit and Spreads

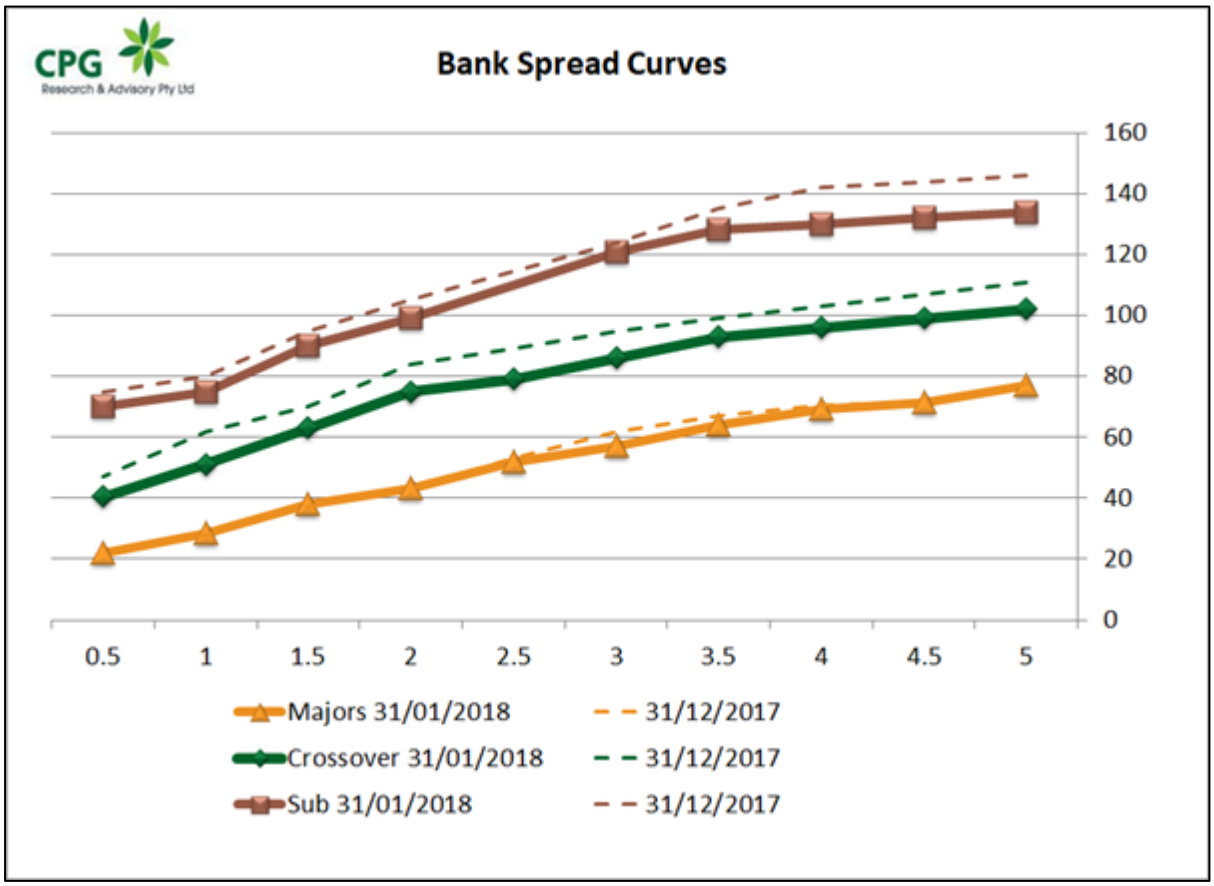
Markets were slightly firmer, with modest gains again setting post-GFC tights:

Credit Indices	31 Jan 18	31 Dec 17	31 Jan 17
iTraxx Australia 5 Yr CDS	57bp	58bp	93bp
iTraxx European 5 Yr CDS	44bp	45bp	74bp
CDX IG North American 5 Yr CDS	47bp	49bp	66bp
CDX HY North American 5 Yr CDS	301bp	307bp	350bp

Investment grade has been particularly strong over the past year, with high yield less so (but with higher income).

Bank FRNs were tighter across the board (term, rating, seniority), although major bank moves were small and representing steepening primarily in the middle durations.

Sub debt is expensive.



High yield bonds set new post-GFC records during the month, bursting through October's low to trade at +323bp spread.

Previous cyclical lows took the index to the +250bp level in 2007 and in the mid-1990s.

Bonds and Interest Rate Outlook

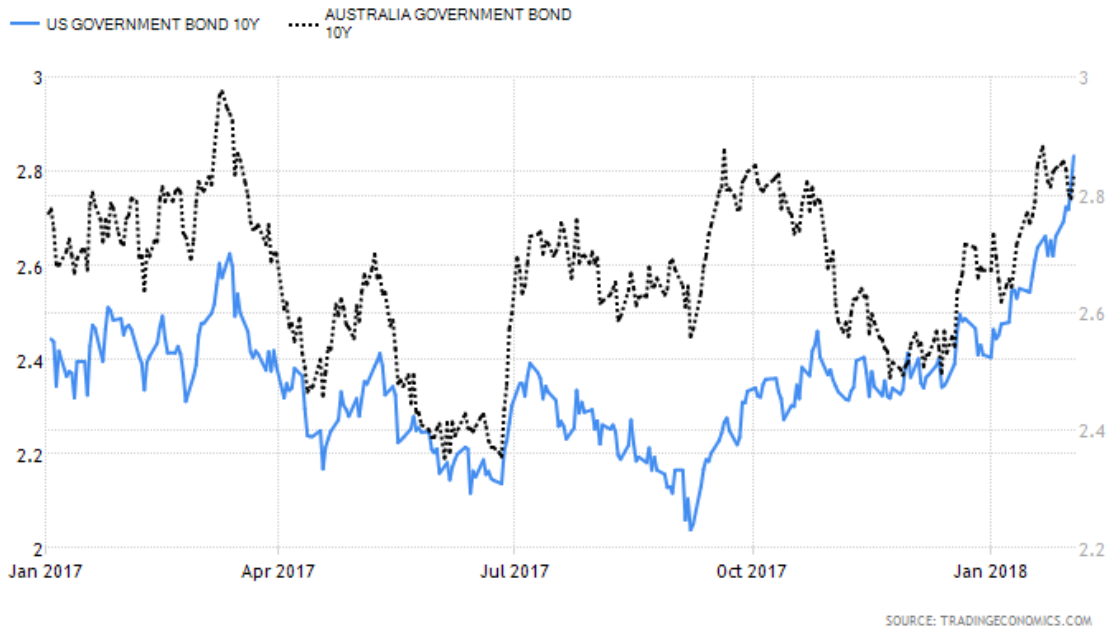
US bonds continued to sell off, with the rising yields accelerating after the passage of tax cuts. In speaking to companies and fund managers, there appears to be an anecdotal view that the economy is strengthening.

It was a month of differentiation in bond markets according to economic conditions – the US has moved into a higher rate environment where other leading markets are well within their trading bands.

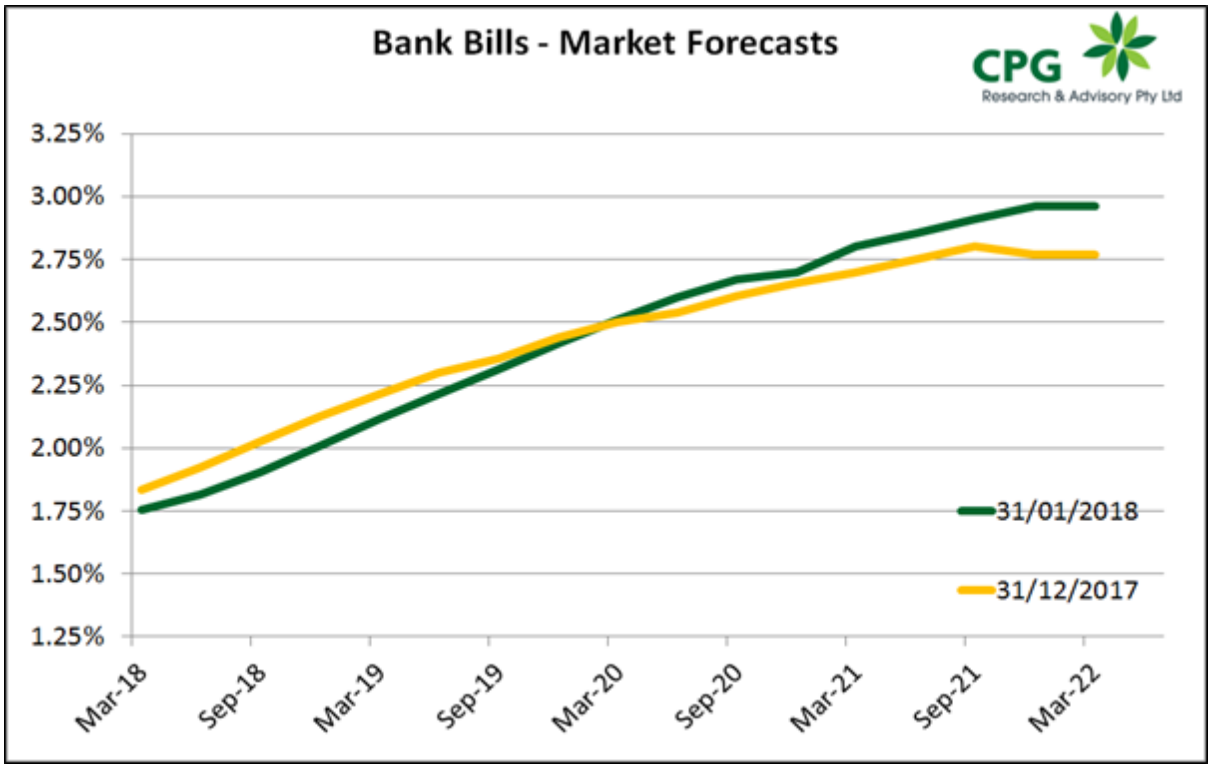
Q4 GDP was estimated at 2.6% p.a., around where the previous 12 months have seen US growth. While unremarkable (and in line with low-growth trading partners Japan and Europe), it was a very late cycle recovery after slowing to 1.2% in the year to 2Q16.

This resilience in the fact of significantly tighter monetary policy – and with tax cuts to kick in from Q1 – are driving a rerating of bonds. **There is also fear in some circles (by no means a consensus) that inflation could be returning.**

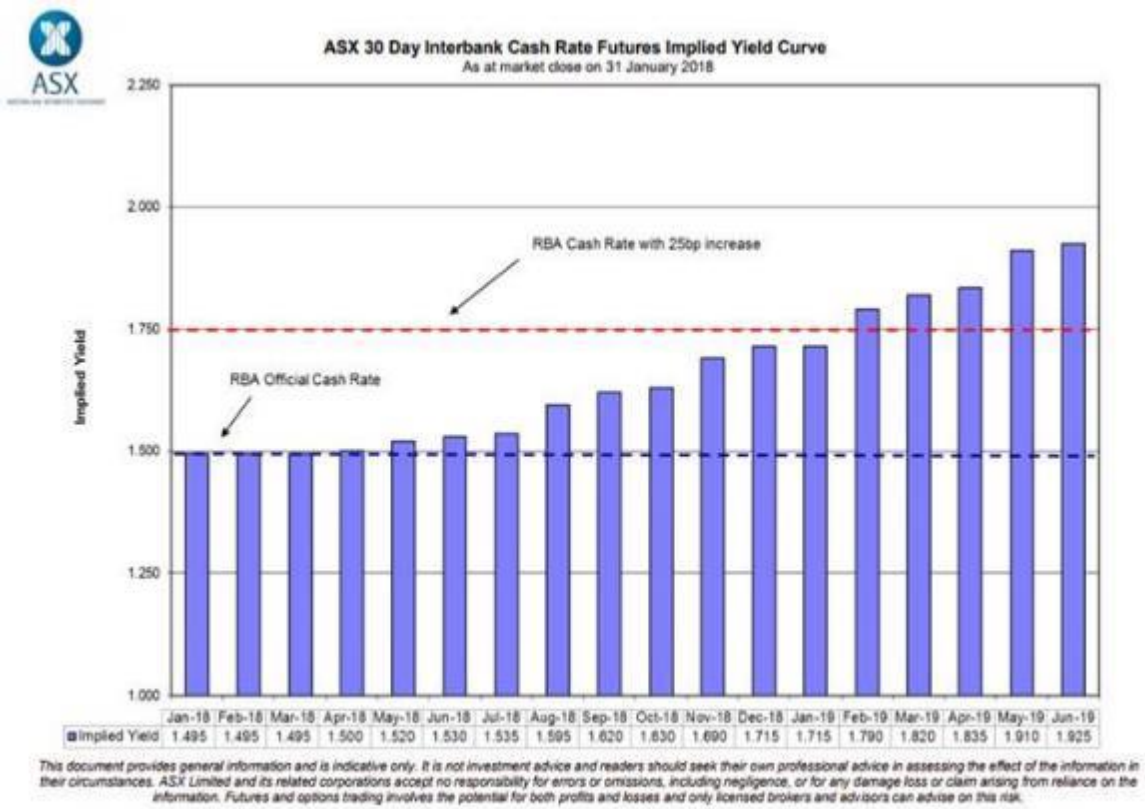
In Australia, bond yields were little changed at 2.82% and did not trade out to year's highs (unlike the US).



Bill futures were little changed, but a steeper curve suggests that the rate increasing cycle is expected to persist longer with more rate hikes (a realistic view, given historical levels for interest rates):



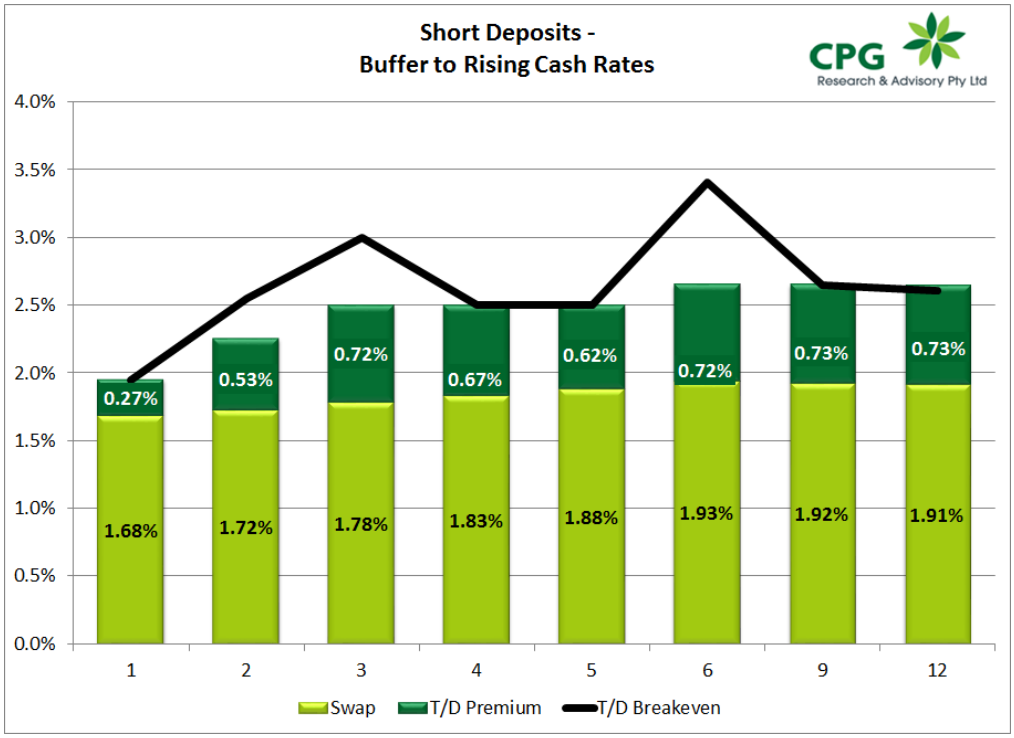
Futures contracts consider a rate hike more likely than not by 3Q18, but it is not fully factored in until early-2019. ***From there, a third is expected by mid-2019:***



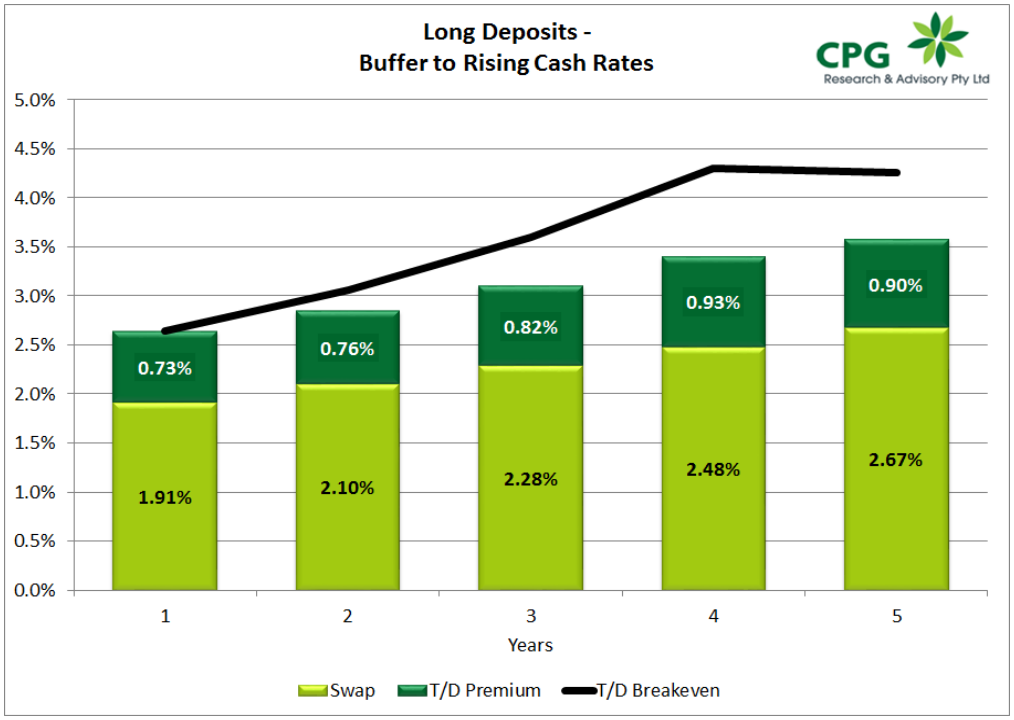
Historically, the RBA has been reluctant to move rates just once. **The RBA put considerable effort into guiding a tightening cycle that they may now need to deliver.**

Term Deposits

Across the short-end of the curve, wholesale deposit margins were little changed:



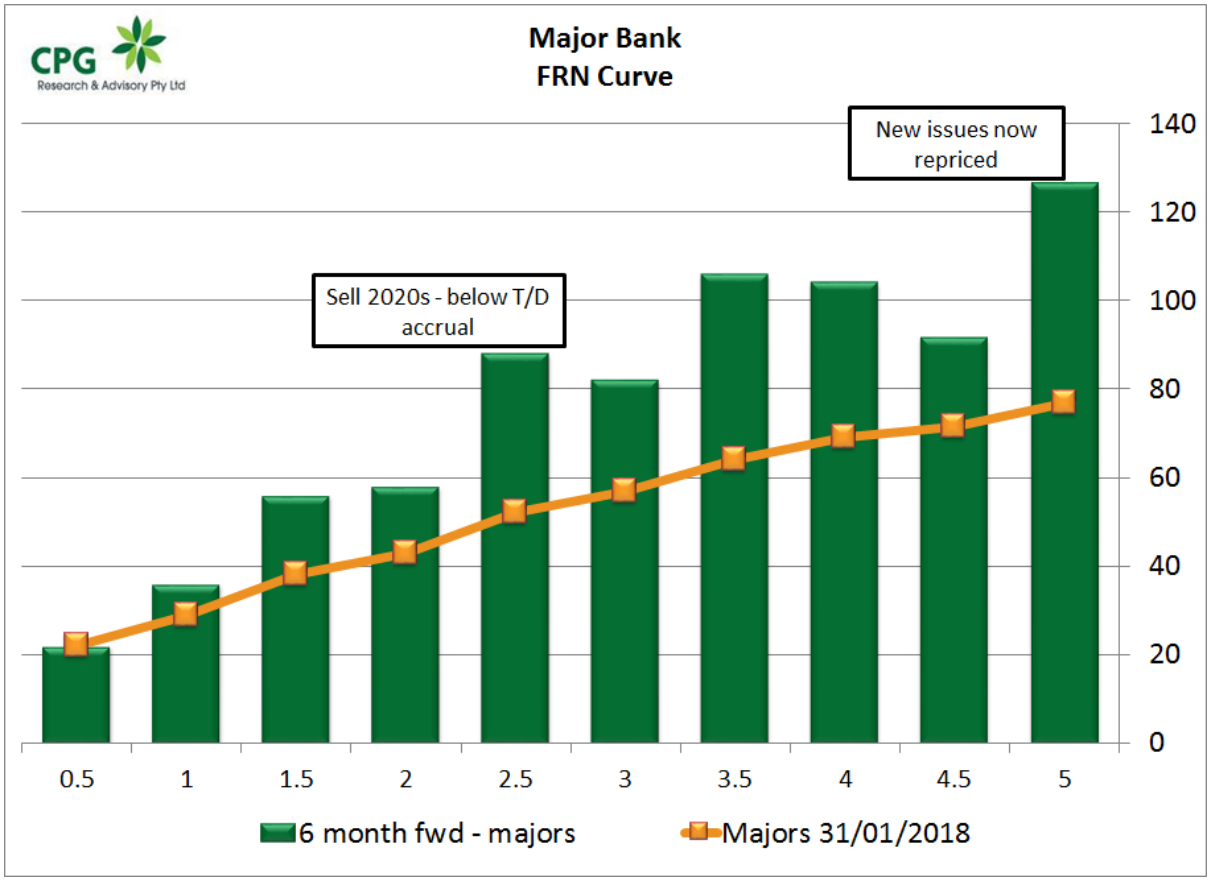
At the longer end, there was also considerable spread compression at the longer end, as deposit yields failed to keep pace with bonds. The out-of-line pricing of 4-year deposits has now normalised:



Major Bank Bonds and FRNs

Investment-grade credit had another strong month, with tighter bank securities as well as non-bank credit. After pausing at the end of 2017, there was a catch-up credit rally:

Major banks were little changed. ***Longer-dated securities show relatively flat returns with a new issue premium – but it is noteworthy that deposit margins have contracted towards FRNs since November:***



This tends to favour switching between FRNs rather than switching into deposits.

Pricing remains tight by post GFC standards. Major banks were, if anything, left behind in the month as other credit sectors were stronger

Repeating our previous detailed modelling: *In this analysis we use a lower hurdle of BBSW+75bp, based notionally on the margins that can be achieved from 1 year T/Ds:*

		Purchase									
		0.5	1	1.5	2	2.5	3	3.5	4	4.5	5
Spread to Maturity	0	***22.0***	***29.0***	***38.0***	***43.0***	***52.0***	***57.0***	***64.0***	***69.0***	***71.5***	***77.0***
	0.5		36.0	46.0	50.0	59.5	64.0	71.0	75.7	77.7	83.1
	1			56.0	57.0	67.3	71.0	78.0	82.3	83.6	89.0
Sale	1.5				58.0	73.0	76.0	83.5	87.6	88.3	93.7
	2					88.0	85.0	92.0	95.0	94.3	99.7
	2.5						82.0	94.0	97.3	95.9	102.0
	3							106.0	105.0	100.5	107.0
	3.5								104.0	97.8	107.3
	4									91.5	109.0
	4.5										126.5
	5										

Stress Tests

	Widening	bp capital writedown									
	20%	2	6	11	17	26	34	45	55	64	77
	50%	5	14	29	43	65	85	112	138	161	193
	100%	11	29	57	86	130	171	224	276	322	385
Mod Sharpe @ 80 bp		-26.36	-7.59	-2.11	-1.28	0.31	0.15	0.58	0.45	0.32	0.60
Proportionate spread to breakeven				*+420%*	*+202%*	*+128%*	*+99%*	*+73%*	*+62%*	*+44%*	*+41%*

[**The top line is simply a "hold to maturity" scenario**, *i.e.* a sale with 0 years remaining, and therefore simply shows the running yield.]

A rolling FRN strategy offers better than T/D margins again, even without going to lower credits. Major banks will likely issue around +80, targeting +100 on a 2-year view; this is now 30-35bp better than 2-year deposit margins.

From 2016, we introduced a new measure: Breakeven. This examines how much widening can be supported and still break even to benchmark in 12 months.

For example, **a 5-year security purchased at +77bp could be marked *41% wider* than today's 4-year** (at +97bp, *vs* the current +69bp for a 4-year security) in a year's time, with the excess income offset by -77bp of capital loss.

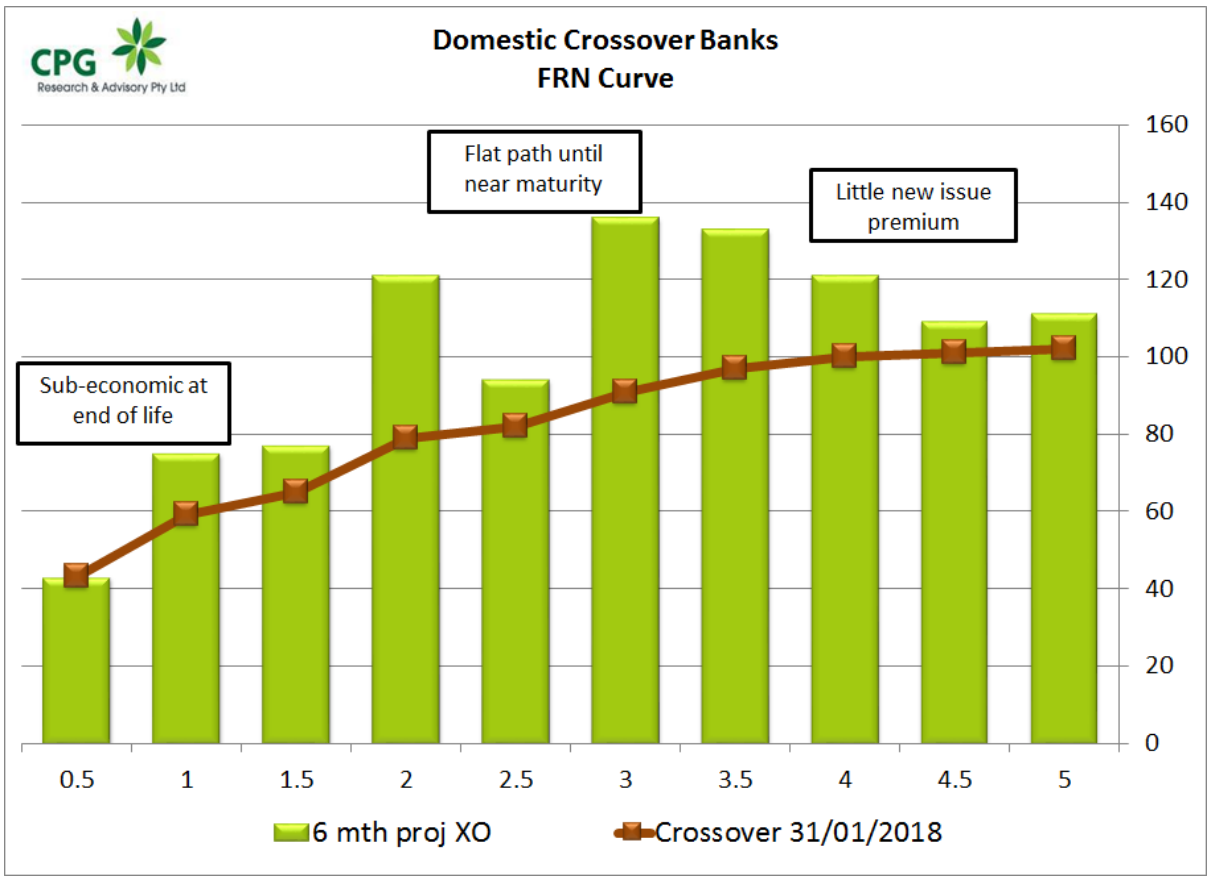
Some steepening of the curve around the 3-4 year area has improved breakeven measures during the month.

Domestic 'Crossover' Rated Banks

Previously described as the A- banks, this is now the Bendigo / BoQ pair that has "split" ratings (A range at Moody's, and BBB range at S&P). The Moody's downgrades of June do not affect this classification.

Yields are lower for all terms, tightening an average of 8bp. *A spread to major banks of high-20's across the board is historically quite tight.*

Increasingly, securities are saleable as much as 18 months out – relevant to investors either facing BBB Policy issues, OR seeking to free additional capacity for new placements.



The overall higher level of the credit curve creates the **potential for returns above the +105bp area** that could be realistically targeted with deposits or major bank FRNs.

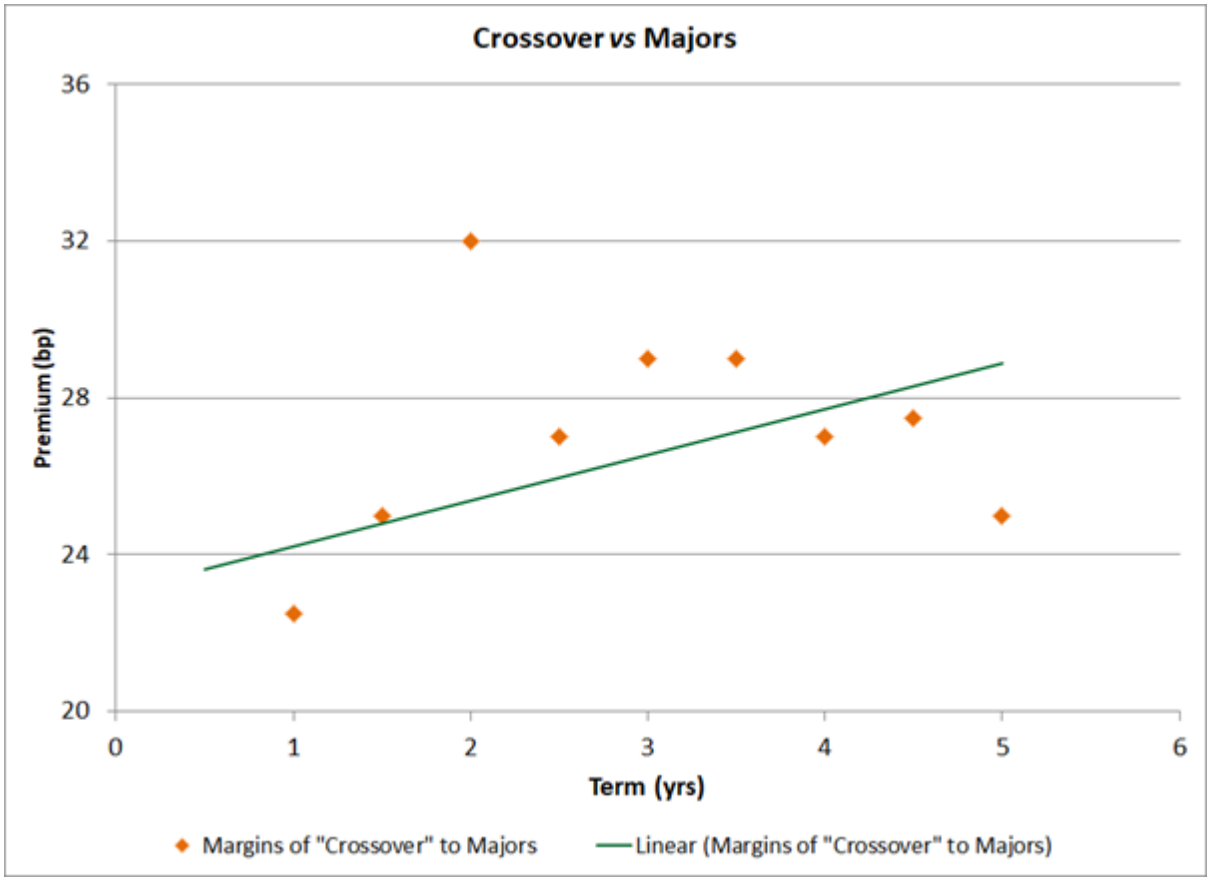
In the smaller institutions, a different dynamic is observed. The issue margin of ~+150bp exceeds what can be targeted from a trading strategy in more liquid names. ***"Buy and hold" investors can again target the same returns as more active investors – at the expense of credit rating.***

		Purchase									
		0.5	1	1.5	2	2.5	3	3.5	4	4.5	5
Spread to Maturity	0	***43.0***	***59.0***	***65.0***	***79.0***	***82.0***	***91.0***	***97.0***	***100.0***	***101.0***	***102.0***
	0.5		75.0	76.0	91.0	91.8	100.6	106.0	108.1	108.2	108.6
	1			77.0	99.0	97.3	107.0	112.2	113.7	113.0	112.8
Sale	1.5				121.0	107.5	117.0	121.0	121.0	119.0	117.9
	2					94.0	115.0	121.0	121.0	118.6	117.3
	2.5						136.0	134.5	130.0	124.7	122.0
	3							133.0	127.0	121.0	118.5
	3.5								121.0	115.0	113.7
	4									109.0	110.0
	4.5										111.0
	5										

Stress Tests

	Widening	bp capital writedown									
	20%	4	12	20	32	41	55	68	80	91	102
	50%	11	29	49	79	103	137	170	200	227	255
	100%	22	59	98	158	205	273	339	400	454	510
Mod Sharpe @ 80 bp		-8.60	-0.42	-0.15	1.30	0.67	1.03	0.80	0.62	0.49	0.41
Proportionate spread to breakeven				*+370%*	*+196%*	*+110%*	*+73%*	*+66%*	*+50%*	*+38%*	*+34%*

Breakeven levels show comparable resilience against spread widening as the AA banks this month. The premium to AA range historically low (post-GFC) and flat:



Other Banks – Senior

Bank of China's 2019 tightened another -1bp to +79bp; the April 2022s have firmed in line with their shortening term (now 4½ years) and trade at +108bp although have been a severe laggard in a very strong credit market. Chinese banks have traded satisfactorily in absolute terms, but have been relative underperformers in line with our long-term preference for other regions for debt.

Credit Suisse's most recent issued notes have continued to trade well. With the ongoing rally in credit markets and a generally positive environment in Europe, they traded 3bp tighter, to +74bp at month-end, or around $103.56 clean. **2018's and even 2020's are now very saleable, at +34bp and +60bp respectively. These now trade as Australian majors – somewhat paradoxically given ongoing trading losses from the European banks.**

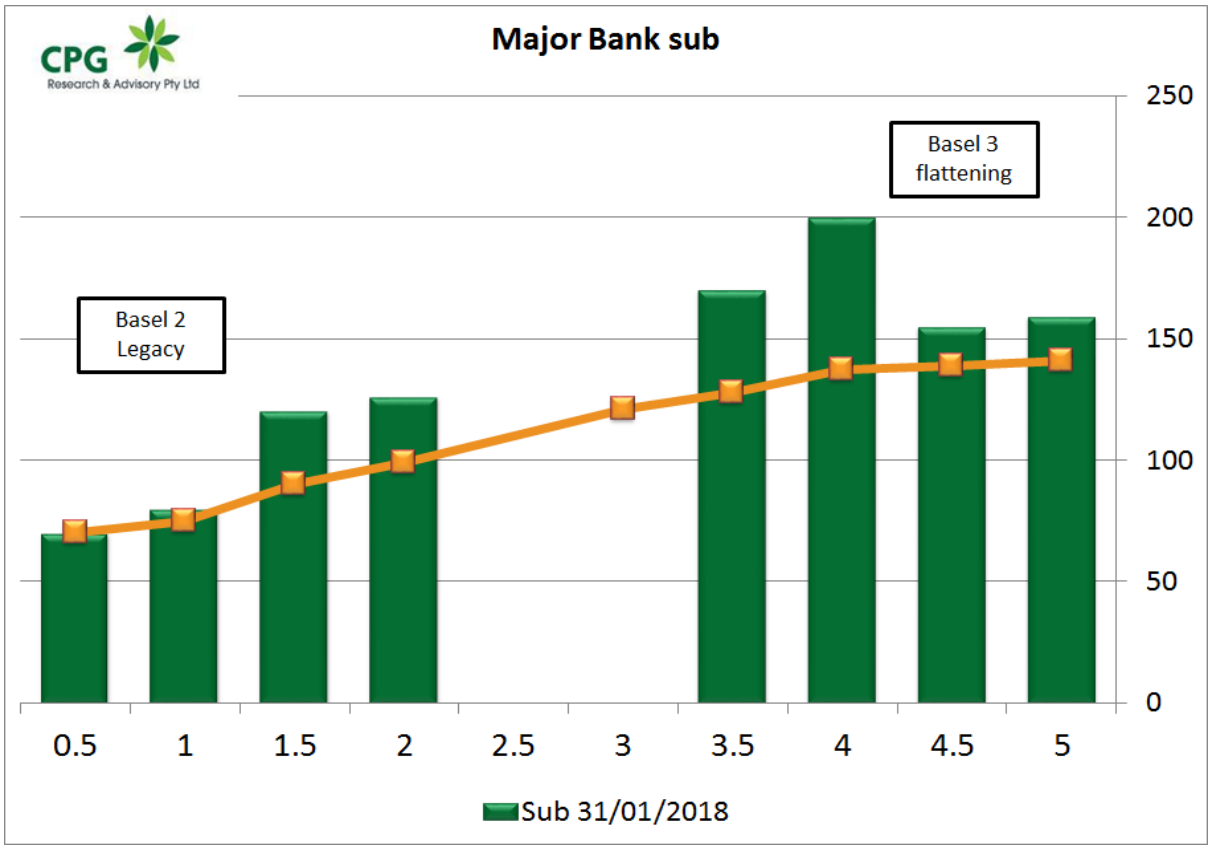
Rabobank has also traded well – their 2021s marked at +62bp, and the 2022s at +71bp (-3bp lower). They trade near Australian majors. This is a massive turnaround from the conditions applying in Europe at the time of the sovereign debt crises, and reflects a perceived de-risking and improving performance on measures like budget deficits and unemployment although **we note that it was only June that some smaller banks failed**.

We highlight another significant loss reported by Deutsche Bank at month end, which contributed to broader stockmarket weakness. Not unique to Deutsche, this highlights both difficult in earning money during negative interest rates, and asset write-offs as they shrink balance sheets. Given a smaller asset base, losses are not necessarily destructive to capital ratios though.

Sub Debt

Sub debt has been tightening for both Basel II and Basel III, and the two have effectively converged.

Basel II sub debt is now very short-dated, and generally trades as though a deposit. While it is necessary for some investors to hold liquid assets, ***we would not seek to take unpaid non-call risk***:



At the short end, major bank 2017 call (Basel 2) sub-debt was again tighter, comparable with deposit rates. The market is implying **minimal risk of non-call**.

We are <u>sellers of both older and newer sub-debt</u>, which are comparable to some T/D margins or less. <u>It does not feel that investors are adequately rewarded for owning what is explicitly a "bail in" instrument intended to be lost in a crisis.</u>

Consider the excess spread:

- At +135 area, sub-debt pays around double comparable senior debt but with both at decade tights.
- The implication of a 60bp premium is that any major bank needing public capital (at which point a declaration is likely to be made bailing in the sub-debt) is a *160-year event*.
- In that context, the Great Depression was 85 years ago, the 1990 crisis that saw a number of state banks need public capital and Westpac need recapitalisation. That was less than 30 years ago.
- The GFC was around 10 years ago.
- The Cypriot banking crisis only 5 years ago.

The recent 0% recovery in Spain and Italy even on sub-debt implies that sub-debt may in practice be bailed in during the <u>same</u> events as hybrids Sub-debt trades around 60% tighter.

Major banks have repeatedly affirmed strongly that they intend to call securities at the first opportunity unless explicitly prohibited by regulators. They believe the reputational risk of not calling would result in significant upheaval from investors.

WBCHA was called on schedule last year, leaving WBCHB as the legacy listed sub-debt. It finished at +144bp for the month, 3bp wider than Dec 2017:

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