CPG
Research & Advisory Pty Ltd

Market Update:

Fixed Interest Analytics

March 2018

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Credit and Spreads

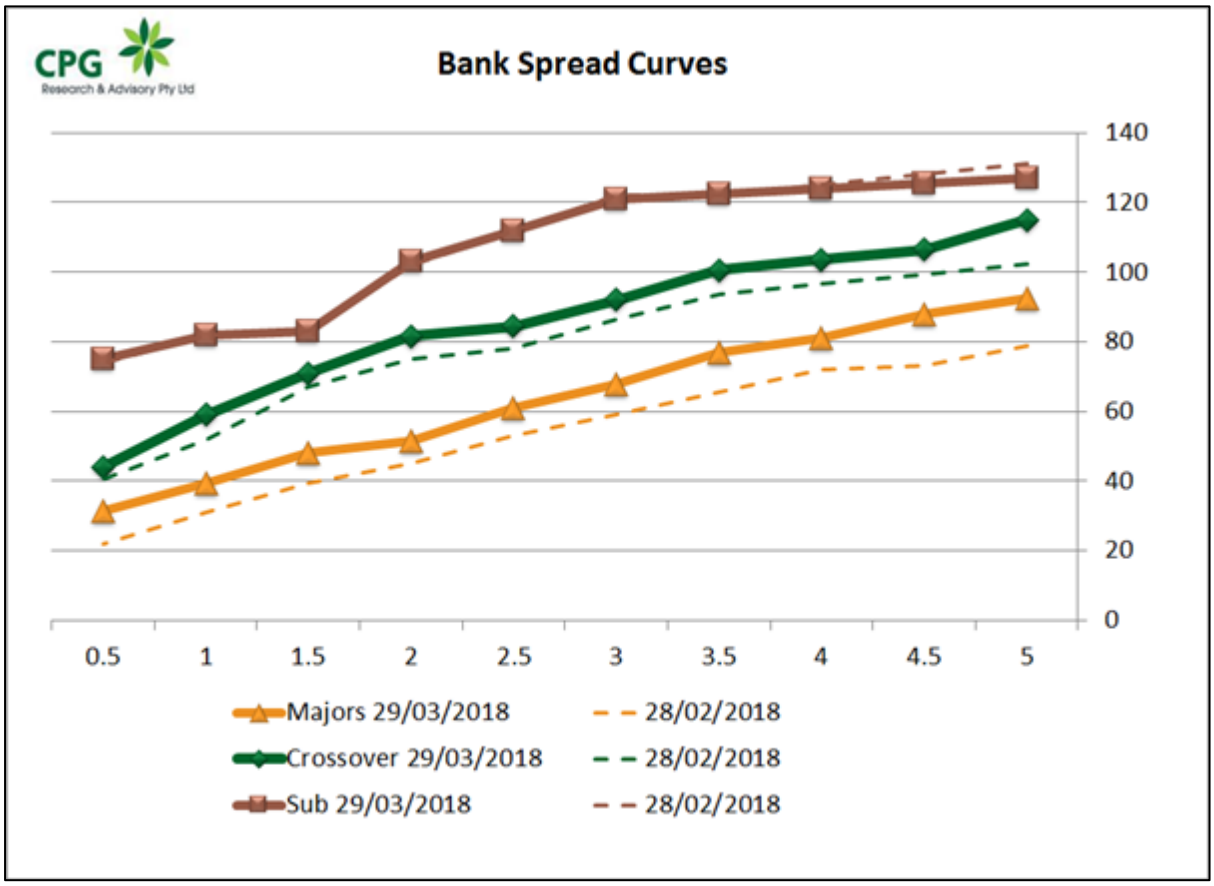
Global credit was weaker on trade war anxiety between the two largest economies in March. Australia underperformed:

Credit Indices	31 Mar 18	28 Feb 18	31 Mar 17
iTraxx Australia 5 Yr CDS	70bp	59bp	84bp
iTraxx European 5 Yr CDS	60bp	52bp	74bp
CDX IG North American 5 Yr CDS	66bp	56bp	66bp
CDX HY North American 5 Yr CDS	360bp	334bp	338bp

Bank FRNs marginally widened across the board, including major banks, for as much as 15bps. Coupled with steeper yield curves, that has significantly increased target returns over a holding period.

Deposit margins were mixed in March – rates again moved less than bond yields. At the short end, this tended to compress margins further while they expanded at the longer end.

Basel III sub debt traded stronger, despite negative sentiment in markets overall. Pricing shown may be "stale."



High yield bond spreads **widened as well although not materially, from +347bp at end of February to +372bp** (*BoA Merrill Lynch HY Index, option-adjusted*).

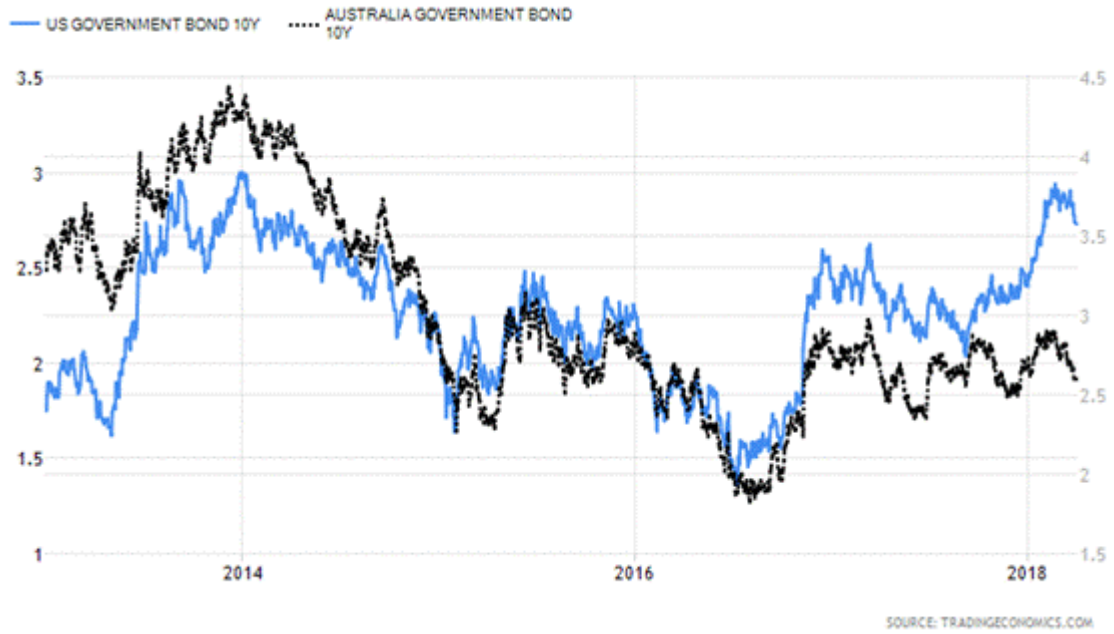
Bonds and Interest Rate Outlook

February saw panic over the potential for an overheating economy. Bond yields had risen sharply, to the point where they alarmed the stockmarket. Even during the correction, yields tracked sideways rather than seeing a common "flight to safety."

March saw an entirely different panic. Pres Trump escalated previous threats against China and other trade counterparties, levying significant new tariffs and other penalties. With some retaliation, the fear that this could hurt the economy sent shares tumbling again. Credit spreads were wider on investor fears. But the early estimates suggesting excessively fast Q1 growth have been significantly pared back, allowing bones to gain. **US yields closed -13bp lower at 2.74%.**

Australian 10-year also traded strongly, aided by rather weak GDP data and the apparent bottoming out of the unemployment rate in November - closing -21bp lower to 2.60%.

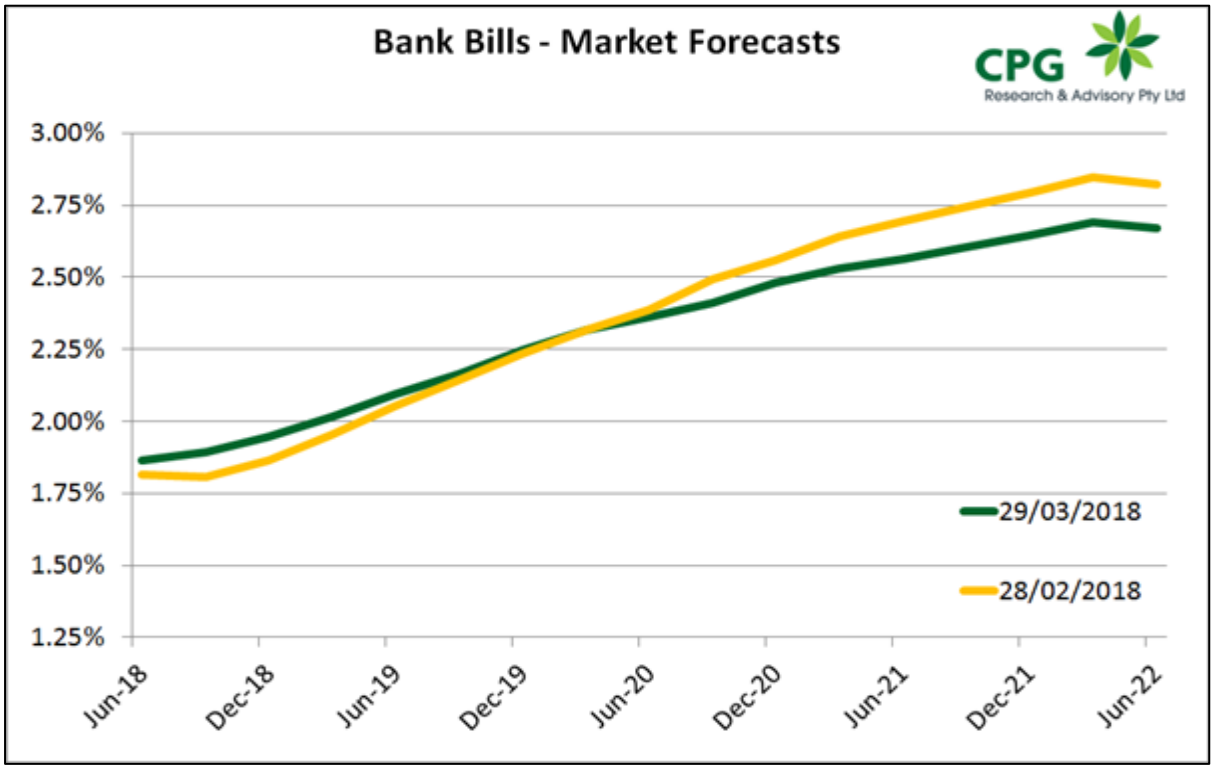
Australian bonds continue to trade inside US yields.



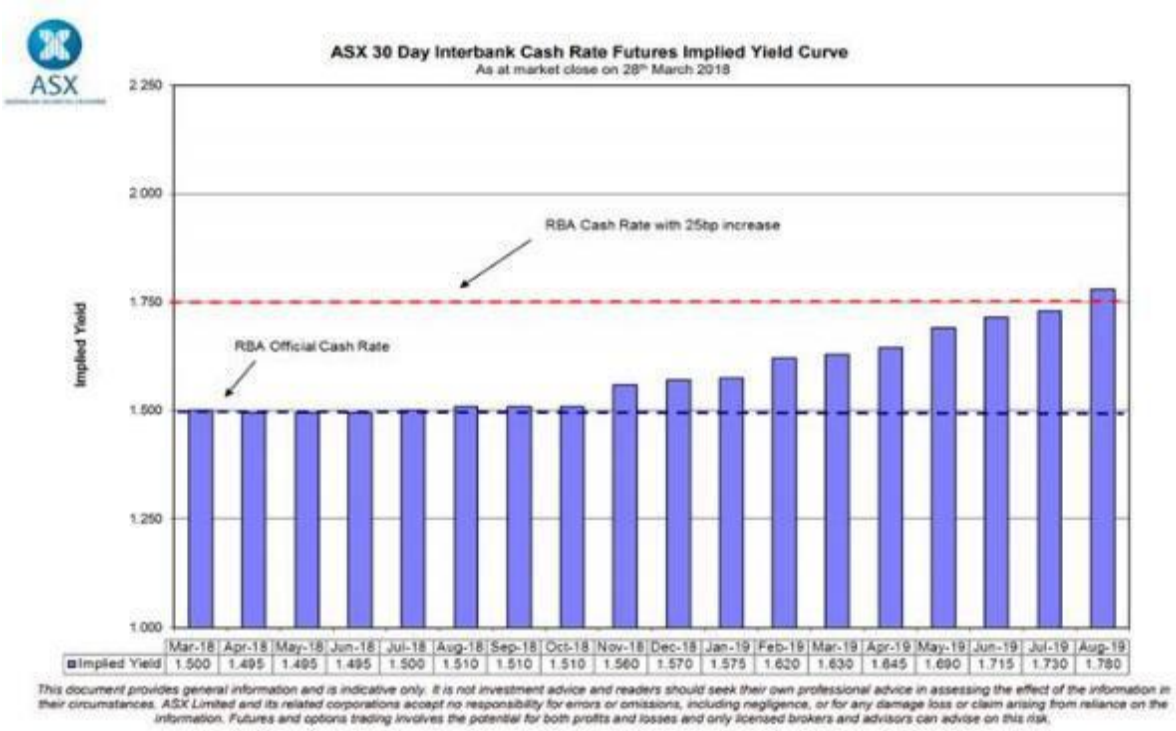
Divergence of policy continues, with the US Federal Reserve increasing rates by 25bp in March but the RBA on hold at the March and April meetings. **There are hints of a firming in their guidance.** CPI expectations for end of 2018 are now just over 2%, rather than just under. Governor Lowe talked about difficult recruiting skilled workers. He would not welcome a higher $A, but describes it as in a trading range (one less reason for easier policy).

However, the RBA did not move to formal tightening bias yet.

Bill futures started to factor in a possible rate hike by RBA, but longer term rates rallied on stockmarket and trade fears.

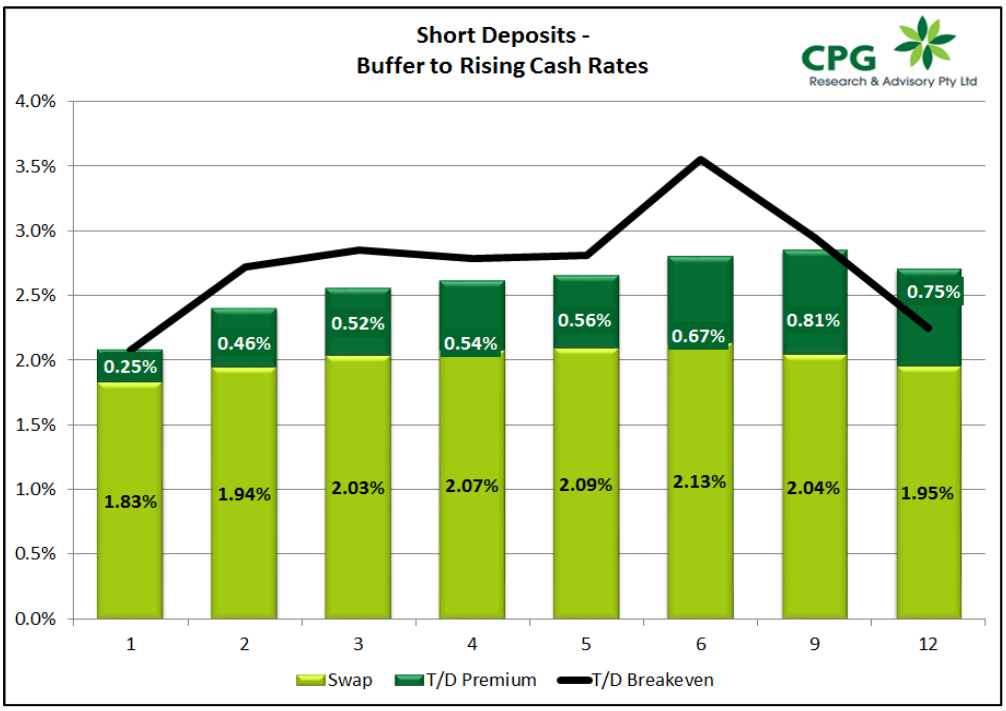


Futures contracts consider a rate hike more likely than not by 3Q18, but it is not fully factored in until early-2019. ***From there, a second is expected by mid-2019:***

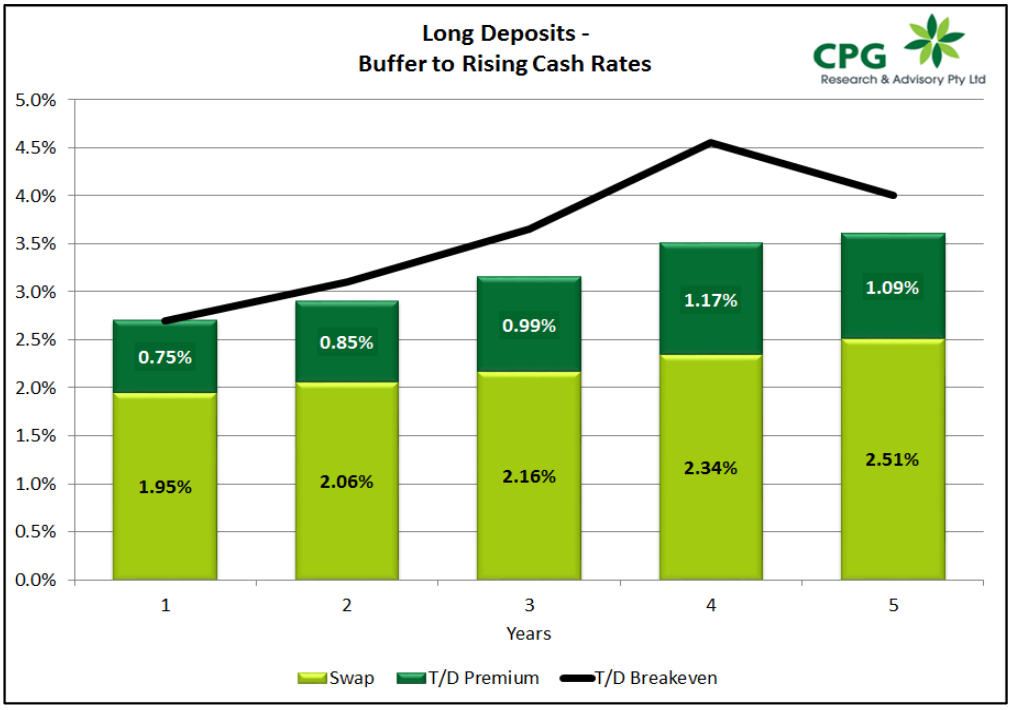


Term Deposits

Across the short-end of the curve, wholesale deposit margins were further squeezed as swap rates increased sharply beyond 2 months:



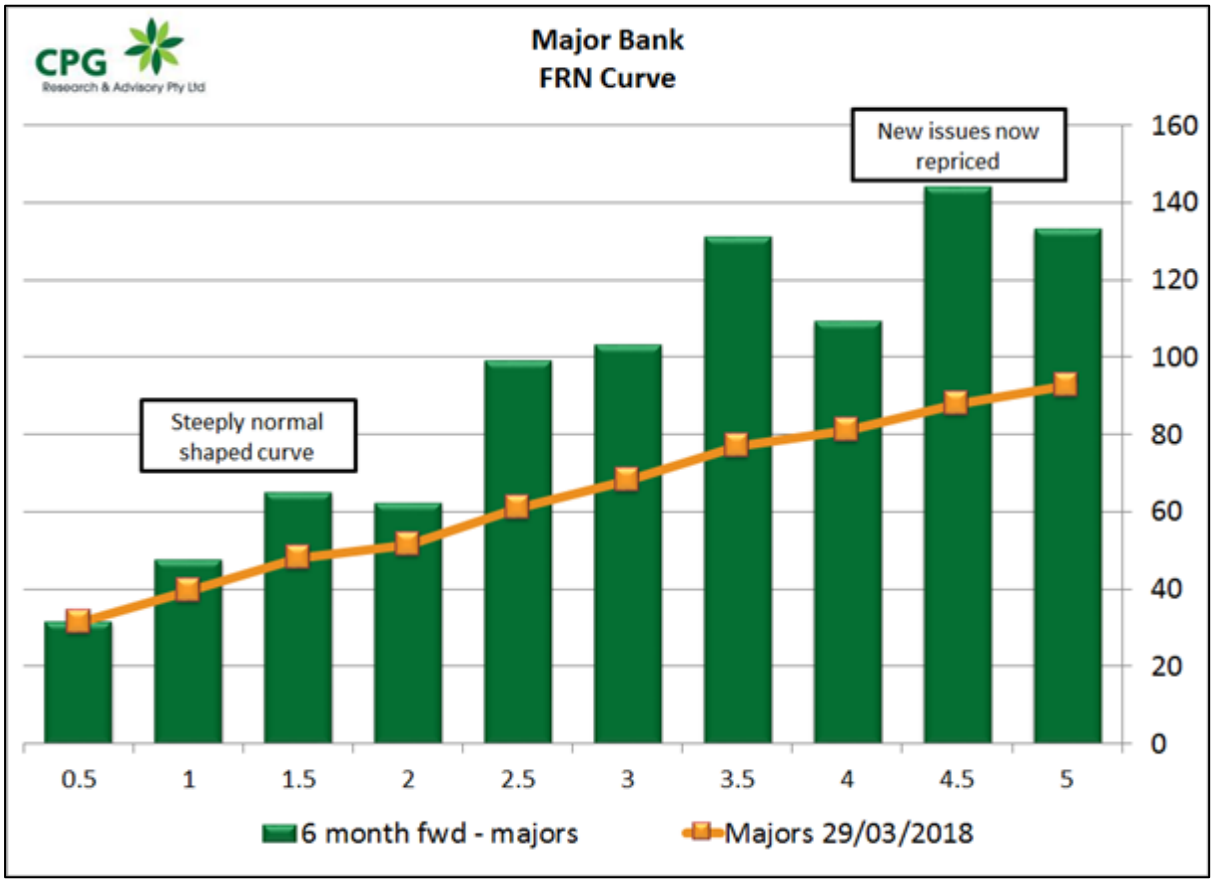
Spreads were wider at the longer end, as swap rates fell and deposit rates were little changed – again, 4 years is the point of better value:



Major Bank Bonds and FRNs

Investment-grade credit pulled back as stockmarkets fell:

Major bank spreads also widened – by up to 15bp at the long end – while steepening:



With FRNs wider, they look attractive on a relative and absolute basis.

Repeating our previous detailed modelling: *In this analysis we use a 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	***31.5***	***39.5***	***48.0***	***51.5***	***61.0***	***68.0***	***77.0***	***81.0***	***88.0***	***92.5***
	0.5		47	56	58	68	75	85	88	95	99
	1			65	63	75	82	92	95	102	106
Sale	1.5				62	81	88	99	101	108	112
	2					99	101	111	111	117	120
	2.5						103	117	114	122	124
	3							131	120	128	129
	3.5								109	126	129
	4									144	138
	4.5										133
	5										

Stress Tests

	Widening	bp capital writedown									
	20%	3	8	14	21	31	41	54	65	79	92
	50%	8	20	36	51	76	102	135	162	198	231
	100%	16	40	72	103	153	204	270	324	396	462
Mod Sharpe @ 75 bp		-13.81	-3.48	-0.69	-0.56	0.79	0.69	1.04	0.69	0.87	0.69
Proportionate spread to breakeven				*+360%*	*+161%*	*+112%*	*+98%*	*+78%*	*+60%*	*+48%*	*+44%*

[**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 significant better outlook than T/D margins, even without going to lower credits. Major banks will likely issue around +95, targeting almost +130 on a 2-year view; this is now 30-35bp better than 2-year deposit margins.

The Breakeven measure examines how much widening can be supported and still break even to benchmark in 12 months.

For example, **a 5-year security purchased at +92bp could be marked *44% wider* than today's 4-year** (at +117bp, *vs* the current +81bp for a 4-year security) in a year's time, with the excess income offset by -92bp of capital loss.

We note that an actual new issue rather than on-market purchase would likely be wider than the marks shown, providing additional capital value buffer against further widening.

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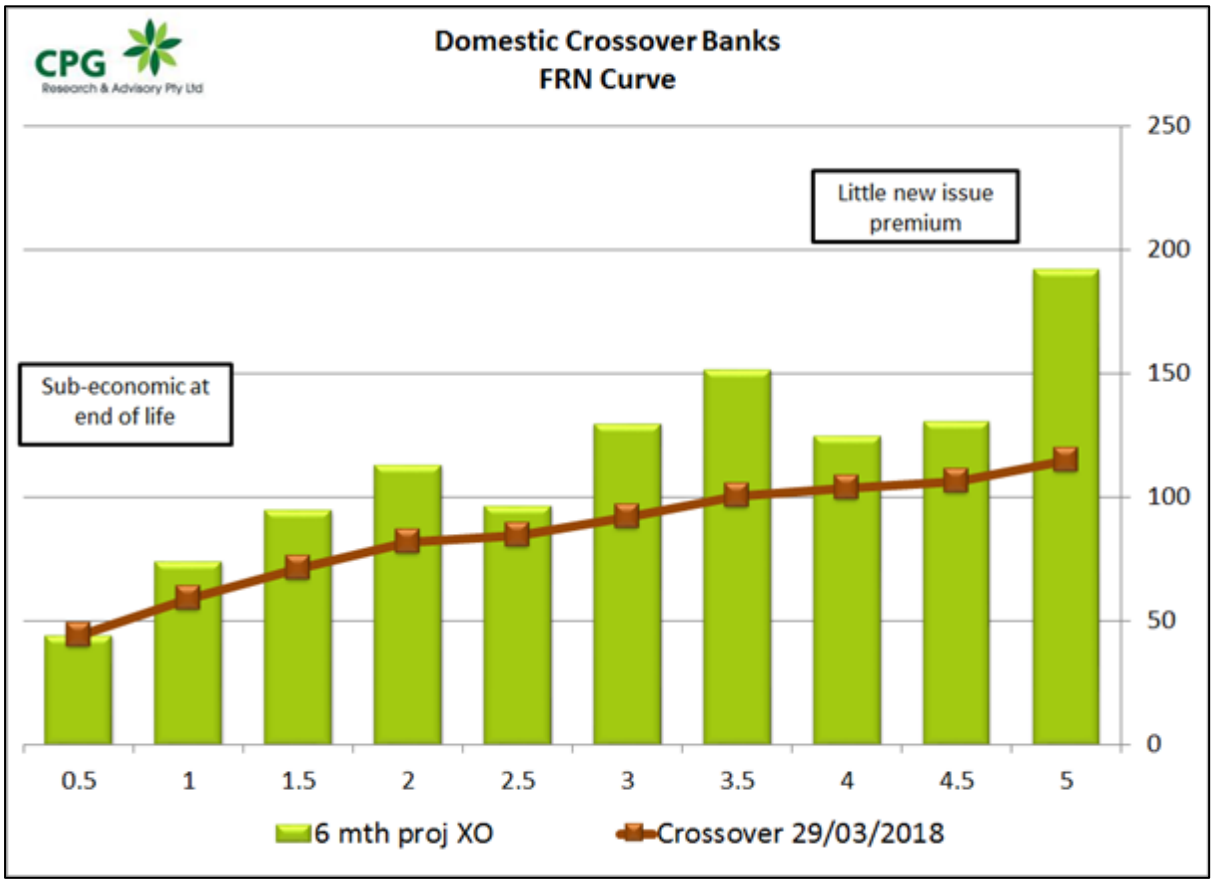
Domestic 'Crossover' Rated Banks

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 higher for all terms, following major banks, widening an average of 7bp. *A spread to major banks of high-20's across the board is historically quite tight, but reasonable.*

Increasingly, securities are borderline saleable less than 2 years out – relevant to investors either facing BBB Policy issues, OR seeking to free additional capacity for new placements. However, for the accrual to be below deposit rates, it is really just the early 2019s that should clearly be rotated out as deposit margins contract further.



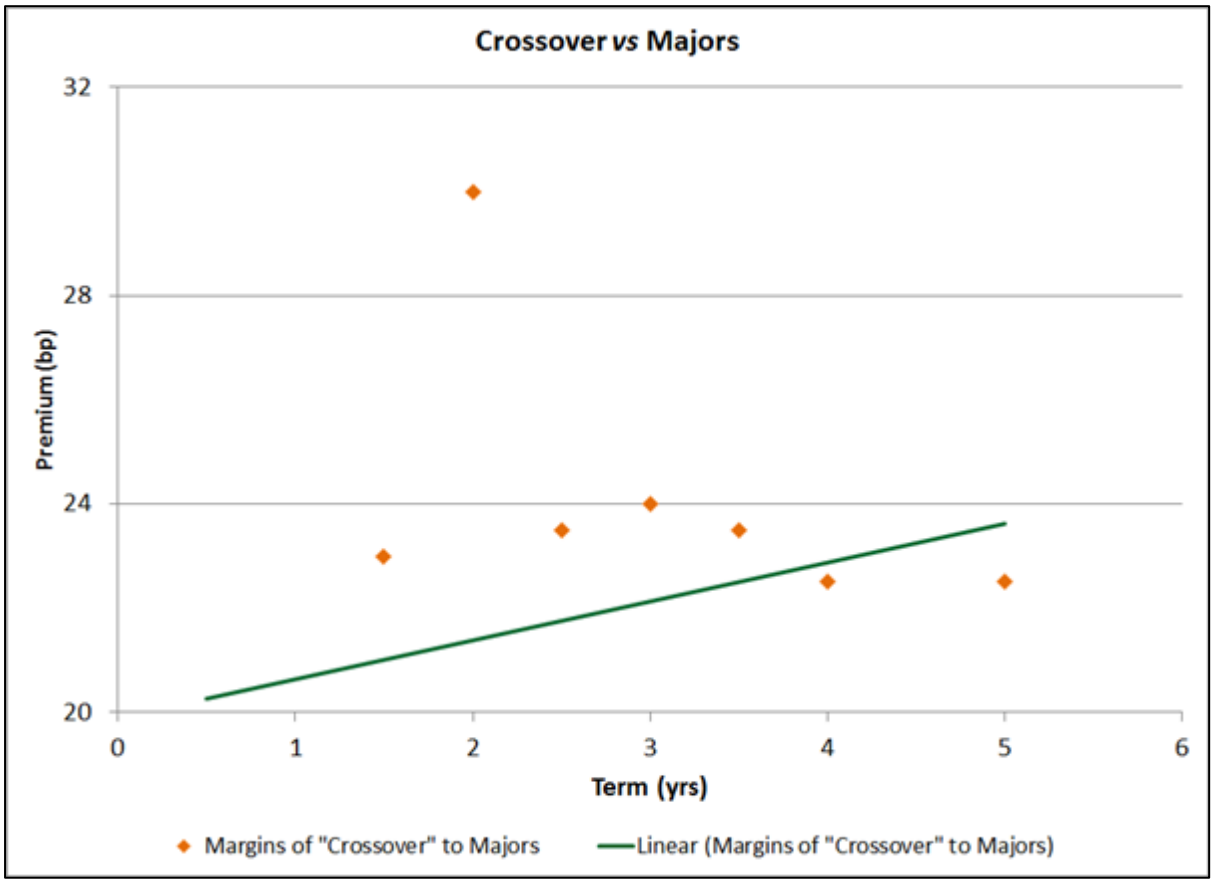
The overall higher level of the credit curve creates the **potential for returns significantly above the +95bp area** that could be realistically targeted with deposits, or the +130bp potential from major bank FRNs. The two year outlook (ignoring new issue premium and trading costs) is for ***up to +150bp.*** The yield uplift is relatively similar whether on a buy-and-hold basis, or explicitly seeking trading.

		Purchase									
		0.5	1	1.5	2	2.5	3	3.5	4	4.5	5
Spread to Maturity	0	***44.0***	***59.0***	***71.0***	***81.5***	***84.5***	***92.0***	***100.5***	***103.5***	***106.5***	***115.0***
	0.5		74	85	94	95	102	110	112	114	123
	1			95	104	102	109	117	118	120	129
Sale	1.5				113	105	113	123	123	124	134
	2					96	113	126	126	127	137
	2.5						130	141	135	134	146
	3							152	138	136	150
	3.5								125	128	149
	4									131	161
	4.5										191
	5										

Stress Tests

	Widening	bp capital writedown									
	20%	4	12	21	33	42	55	70	83	96	115
	50%	11	29	53	81	106	138	176	207	240	288
	100%	22	59	107	163	211	276	352	414	479	575
Mod Sharpe @ 75 bp		-7.05	-0.08	0.94	1.17	0.70	0.99	1.09	0.76	0.63	1.01
Proportionate spread to breakeven				*+389%*	*+178%*	*+99%*	*+70%*	*+68%*	*+51%*	*+38%*	*+41%*

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



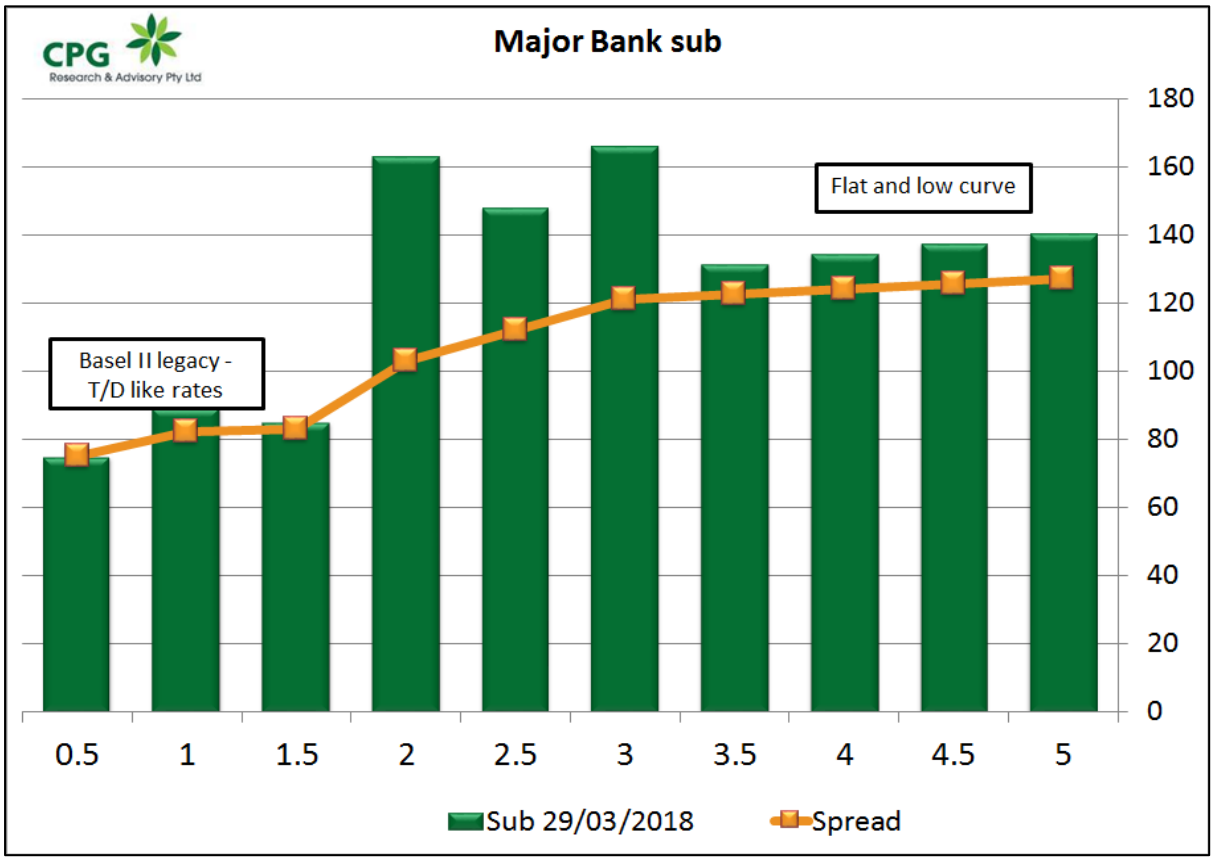
Other Banks – Senior

Bank of China's 2019 tightened -4bp to +75bp; the April 2022s widened and trade at +111bp (+4bp tighter in the month). Chinese banks shrugged off weakness in global markets, and suggestions of economic slowdown – potentially seeing some capital returning home.

Credit Suisse's most recent issued notes were weaker. They traded wider at +80bp, or around $103.20 clean. **2018's and even 2020's are wider as well, at +42bp and +67bp respectively. These now trade as Australian majors – somewhat paradoxically given ongoing trading losses from the European banks.**

Sub Debt

Spreads remain very low, notably at the short end – **Basel II debt trades at deposit margins**:



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>

WBCHA was called on schedule last year, leaving WBCHB as the legacy listed sub-debt. It finished at +187bp for the month, with 46bp wider than February:

It is relatively cheap, but likely to trade in modest volumes and require patient accumulation.

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