CPG
Research & Advisory Pty Ltd

Market Update:

Fixed Interest Analytics

April 2018

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Credit and Spreads

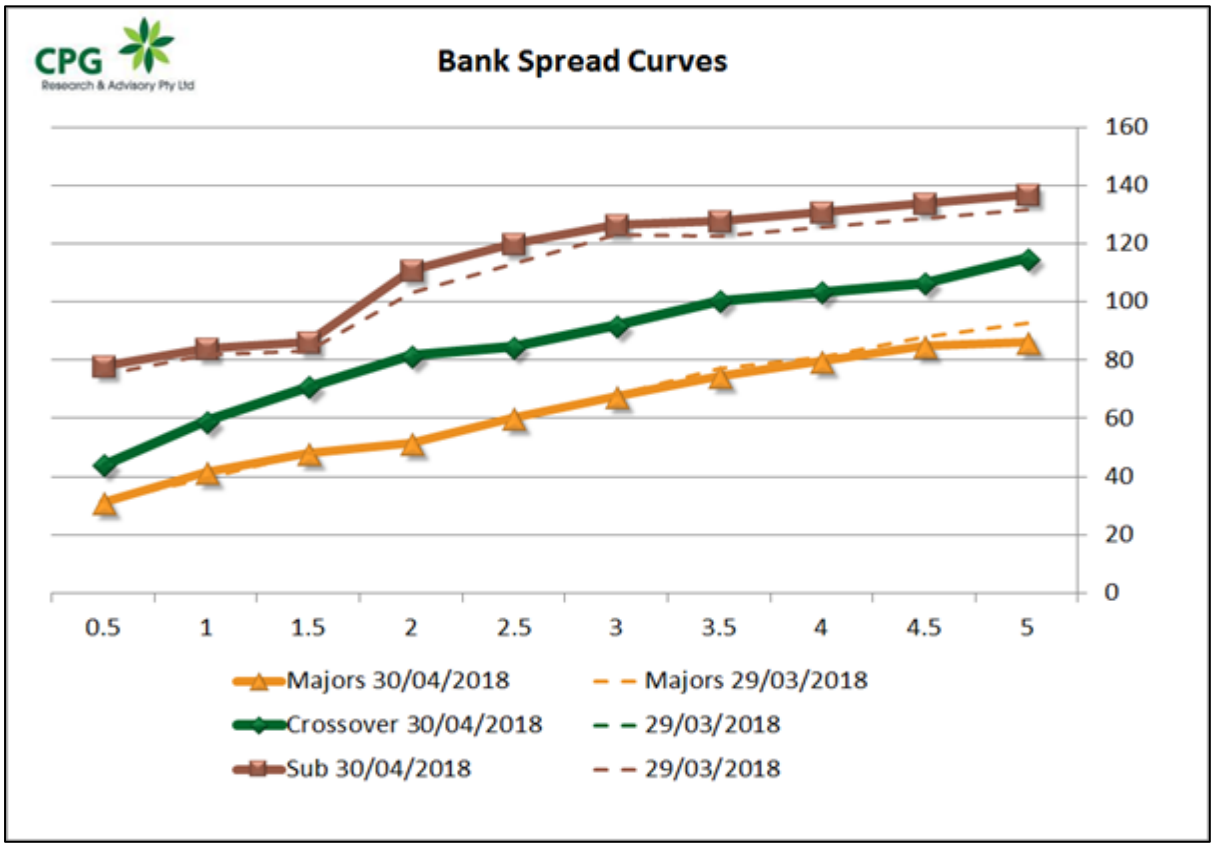
Risk assets recovered in April, as markets took the view that the US and China would produce a reasonable compromise rather than a full-blown trade war. They were also cheered by Korean peace talks.

This saw credit rally across the board:

Credit Indices	30 Apr 18	31 Mar 18	30 Apr 17
iTraxx Australia 5 Yr CDS	65bp	70bp	82bp
iTraxx European 5 Yr CDS	54bp	60bp	67bp
CDX IG North American 5 Yr CDS	61bp	66bp	64bp
CDX HY North American 5 Yr CDS	339bp	360bp	327bp

Bank FRNs performed well, with major bank FRNs narrowed up to 8bp and steepening. They had been heavily oversold in March, as US investors sold assets to return capital. Crossover FRNs (former 'A' rated, now in 'BBB' category) were left behind, and major bank subs widened – confirming our suspicion that March prices were stale.

At the short end, deposit margins increased in April, mainly pushed by higher rates offered by AMP. From longer end, margins further squeezed as swap rates traded higher.



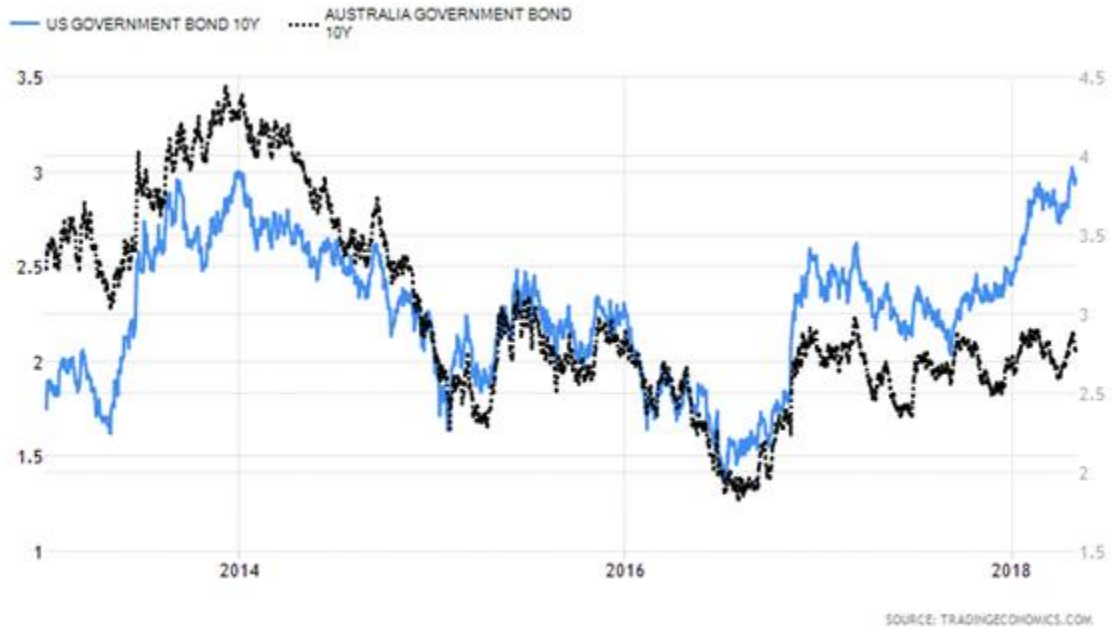
High yield bond spreads **tightened, from +372bp at end of March to +346bp** (*BoA Merrill Lynch HY Index, option-adjusted*).

Bonds and Interest Rate Outlook

Stocks recovered globally on Korean peace talks and de-escalation of trade rhetoric. As panic abated, **US yields closed +21bp higher at 2.95%.** Q1 GDP was estimated at +2.3% p.a., which should not alarm bond markets, but US yields have tended to trend higher regardless of data in recent months.

Australian 10-year also traded weaker, following the US, **closing +17bp higher to 2.77%.**

Australian bonds continue to trade inside US yields, and the gap has widened.

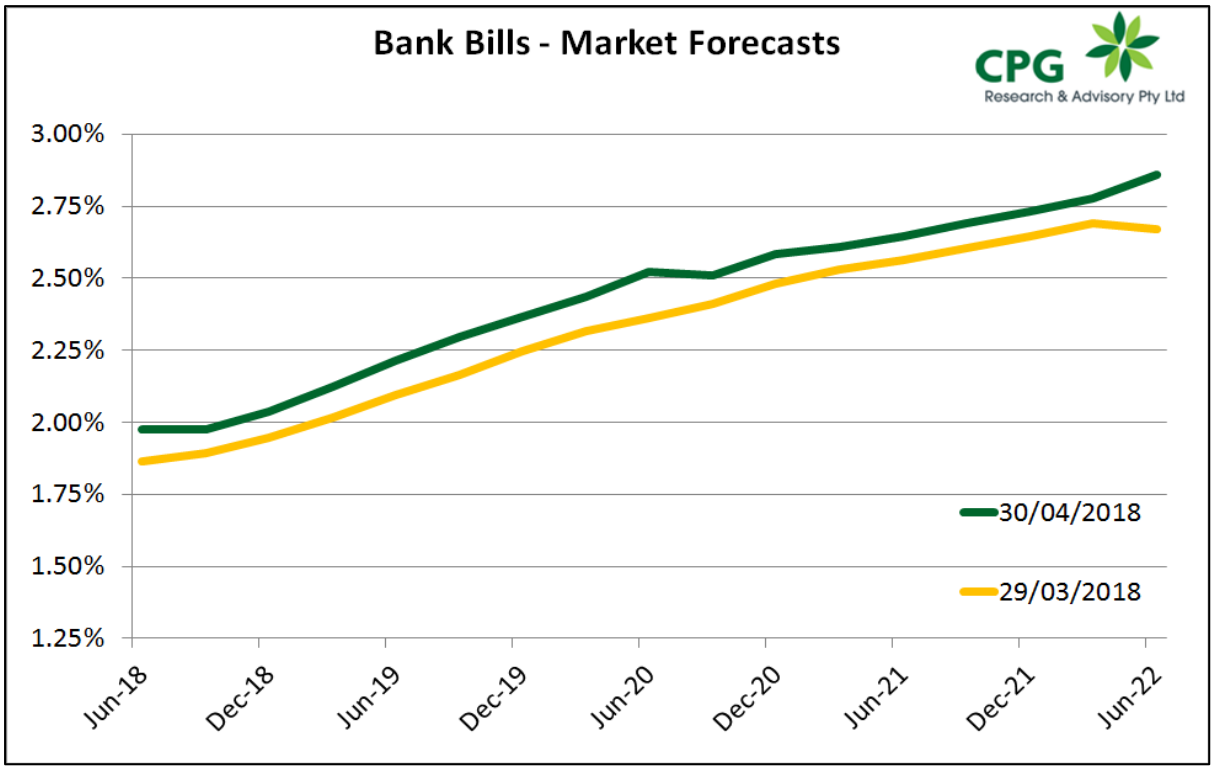


Divergence of policy continues, with the US Federal Reserve increasing rates by 25bp in March but the RBA on hold again in its May meeting. The RBA Minutes acknowledged that the next rate move is up. Its criteria of 2.5% core CPI and lower unemployment (as well as the desire to see stronger wage growth) delays this beyond the Q2 markets had been expecting. It was seen as a weakening of guidance, even if the "*next move up*" wording could have sounded otherwise.

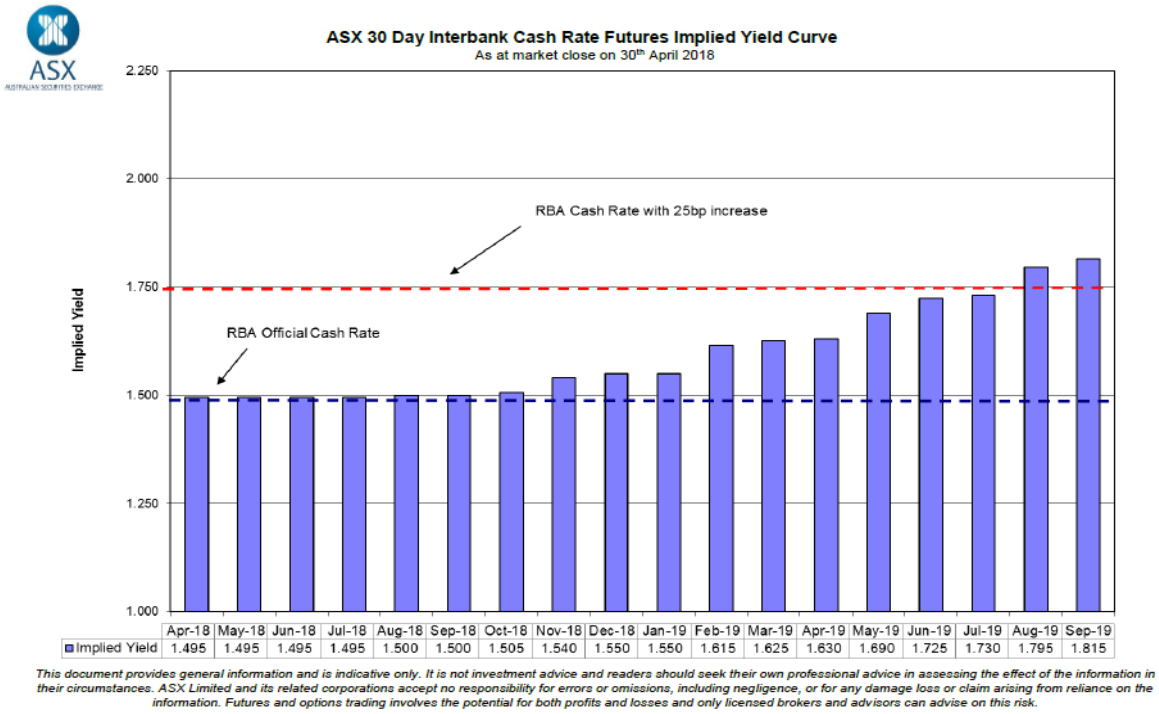
The Treasurer announced that stronger than budgeted tax receipts have removed the need for an NDIS levy. Further tax cuts are also anticipated.

The RBA's May meeting produced no change, and weak employment data looks to have further delayed any pressure domestically.

BBSW is higher, as is the US LIBOR spread relative to the cash rate. This signifies tight money market conditions, probably due to the size of recent flows. Capital returning to the US, the dislocation of the near-shutdown, and similar one-offs have been blamed.

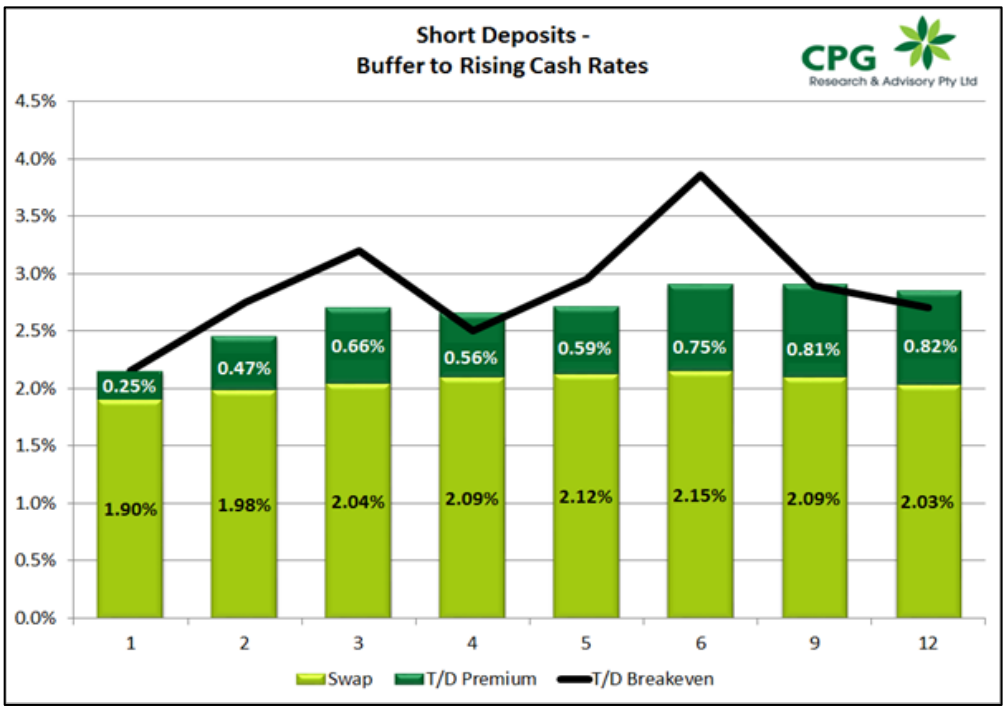


Futures markets now look to as late as mid-2019 to meet the RBA's very high hurdle. ***<u>From there, a second is not expected until 2020 – this seems complacent to us.</u>***

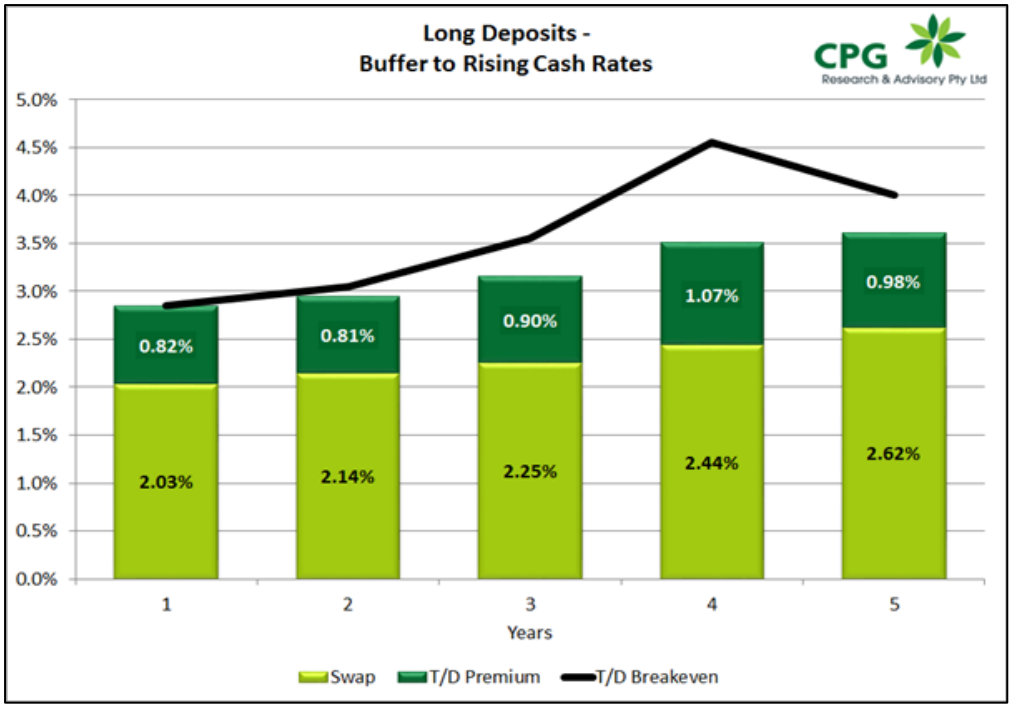


Term Deposits

Across the short-end of the curve, both swap rates and wholesale deposit margins were higher, mainly driven by higher rates from AMP – after a week in the news.

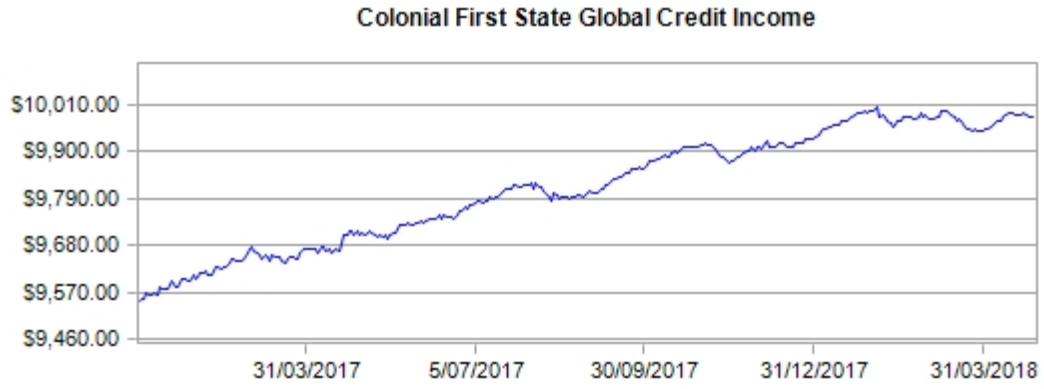


Spreads were tighter at the longer end, as swap rates were higher and deposit rates were little changed – again, 4 years is the point of better value:

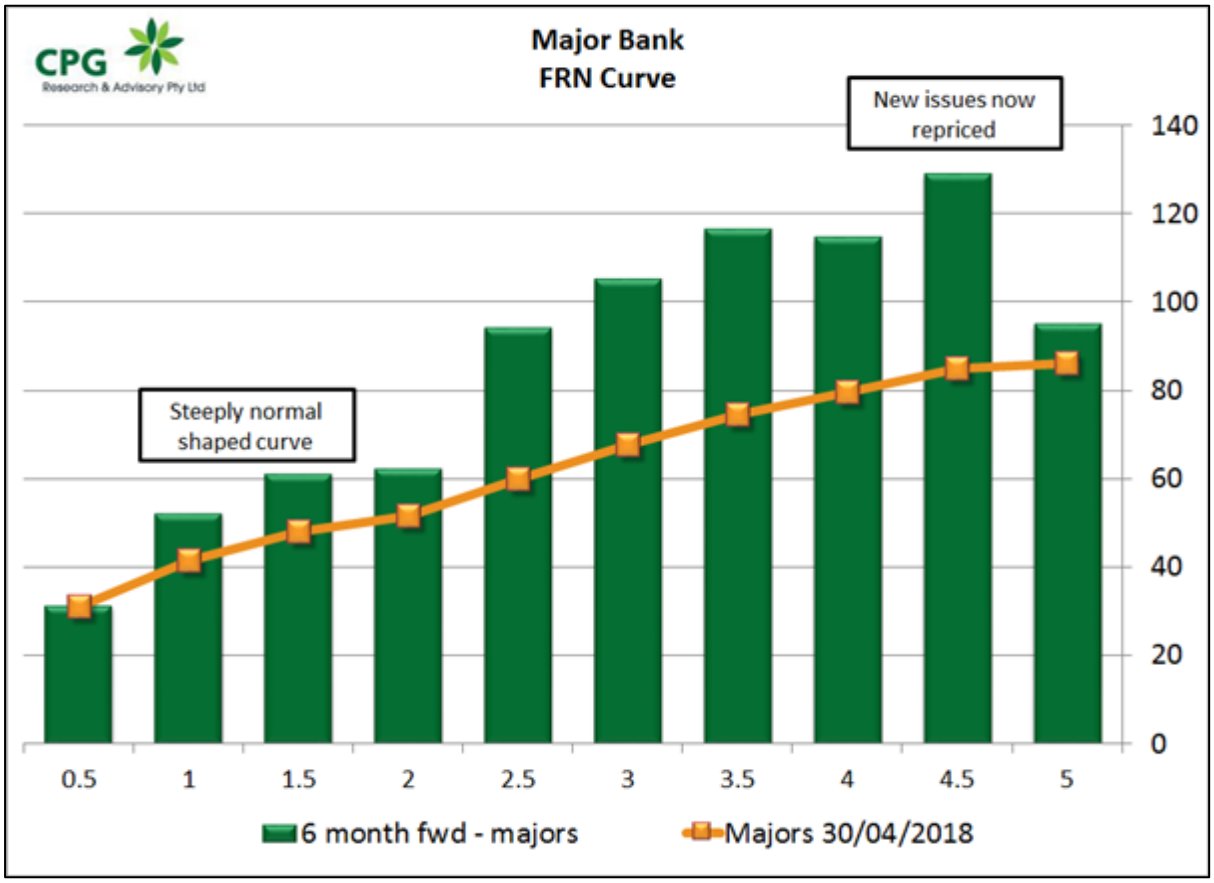


Major Bank Bonds and FRNs

Investment-grade credit recovered from the previous pull back, and is broadly flat:



Major bank spreads tightened – by up to 8bp at the long end – while steepening:



New issues have required a substantial premium over last quote to attract investor demand.

Repeating our previous detailed modelling: *In this analysis we use a hurdle of BBSW+80bp, 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	***31.0***	***41.5***	***48.0***	***51.5***	***60.0***	***67.5***	***74.5***	***79.5***	***85.0***	***86.0***
	0.5		52	57	58	67	75	82	86	92	92
	1			61	61	72	81	88	92	97	97
Sale	1.5				62	78	87	94	98	104	102
	2					94	100	105	108	112	109
	2.5						105	111	112	116	112
	3							116	116	120	114
	3.5								115	122	113
	4									129	112
	4.5										95
	5										

Stress Tests

	Widening	bp capital writedown									
	20%	3	8	14	21	30	41	52	64	76	86
	50%	8	21	36	51	75	101	130	159	191	215
	100%	15	42	72	103	150	203	261	318	382	430
Mod Sharpe @ 80 bp		-15.81	-3.37	-1.32	-0.87	0.47	0.62	0.70	0.56	0.64	0.39
Proportionate spread to breakeven				*+368%*	*+149%*	*+109%*	*+97%*	*+75%*	*+58%*	*+48%*	*+37%*

[**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.]

It can be seen that the existing 5-year securities are **marked relatively too tightly** – indeed, **ANZ had to offer +93bp** in their FRN offer at time of writing. (We recommend the issue.)

A rolling FRN strategy offers significant better outlook than T/D margins, even without going to lower credits. Major banks will likely issue around low 90's (based on the latest ANZ issue from early May), targeting almost +130 on a 2-year view; this is now 33-38bp 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 +86bp could be marked *37% wider* than today's 4-year** (at +109bp, *vs* the current +80bp for a 4-year security) in a year's time, with the excess income offset by -86bp 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. **Rerunning the analysis with an indicative +92bp at 5 years**, consistent with the new issue, produces the following table:

		Purchase									
		0.5	1	1.5	2	2.5	3	3.5	4	4.5	5
Spread to Maturity	0	***31.0***	***41.5***	***48.0***	***51.5***	***60.0***	***67.5***	***74.5***	***79.5***	***85.0***	***92.0***
	0.5		52	57	58	67	75	82	86	92	99
	1			61	62	72	80	88	92	97	105
Sale	1.5				62	78	87	94	98	104	111
	2					94	99	105	107	112	119
	2.5						105	111	112	116	124
	3							117	116	120	129
	3.5								114	122	133
	4									129	142
	4.5										155
	5										

Stress Tests

	Widening	bp capital writedown									
	20%	3	8	14	21	30	40	52	64	77	92
	50%	8	21	36	52	75	101	130	159	191	230
	100%	15	42	72	103	150	203	261	318	383	460
Mod Sharpe @ 80 bp		-15.81	-3.37	-1.32	-0.87	0.47	0.62	0.70	0.56	0.64	0.82
Proportionate spread to breakeven				*+367%*	*+149%*	*+109%*	*+97%*	*+75%*	*+58%*	*+48%*	*+46%*

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 little changed at the long end.

A spread to major banks of high-20's across the board is 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 +90bp 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.***

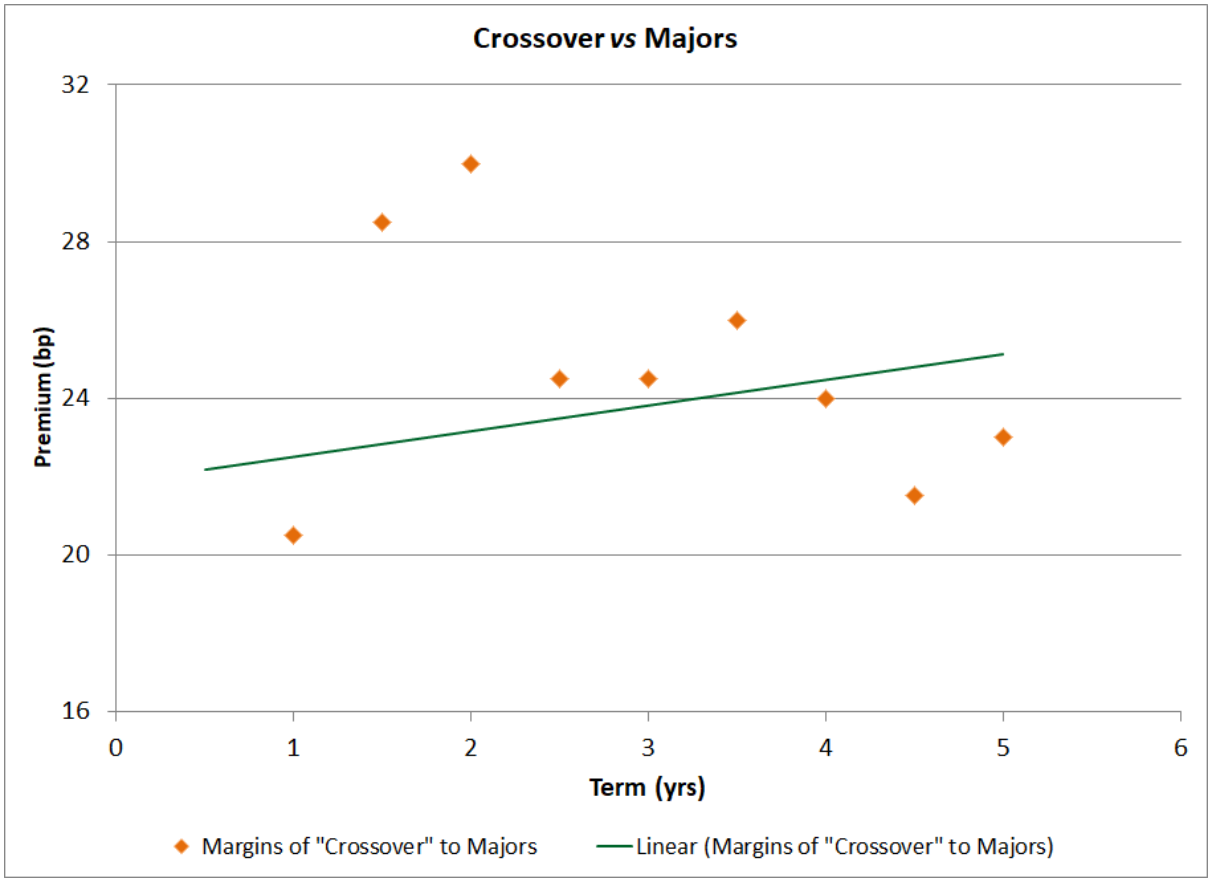
The yield uplift is relatively similar whether on a buy-and-hold basis, or explicitly seeking trading.

		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 @ 80 bp	-8.18	-0.51	0.70	1.01	0.59	0.90	1.02	0.70	0.58	0.97
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 (at the new issue level). The premium to AA range historically low (post-GFC) and normally-shaped:



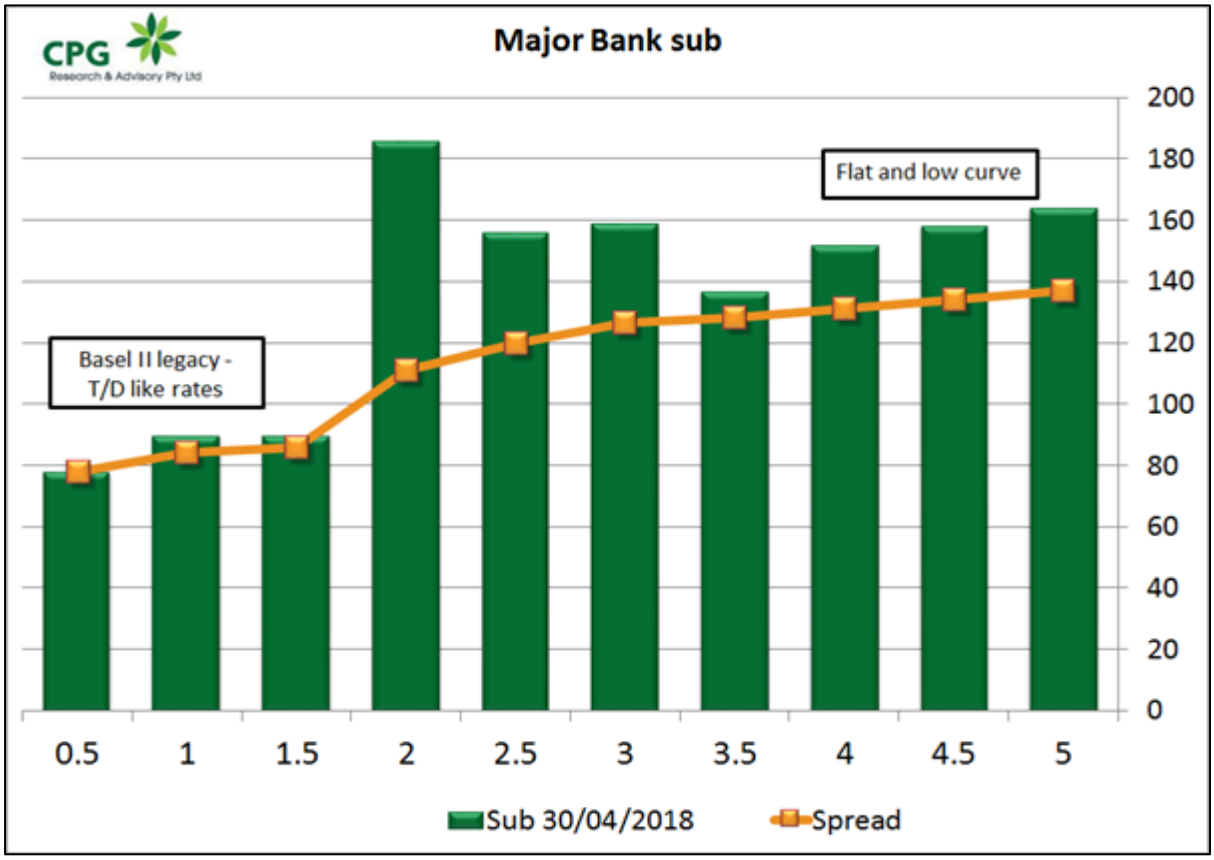
Other Banks – Senior

Bank of China's 2019 unchanged at +75bp; the April 2022s widened and trade at +114bp (+3bp wider in the month) – going against the global trend of stronger credit markets.

Credit Suisse's most recent issued notes were also slightly weaker. They traded wider at +81bp, or around $103.10 clean. **2020's is 1bp wider, at +68bp.**

Sub Debt

Spreads were wider for all terms; as we suspected, the strong marks in March were stale, and subsequent price discovery showed the expected level of widening. **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 +219bp for the month, with 32bp wider than March and looking very cheap:

It is likely to trade in modest volumes and require patient accumulation.

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