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FROM THE AUSTRALIAN FIXED INCOME DESK

Australia Market Commentary

The Australian bond market (as measured by the Bloomberg AusBond Composite 0+ Yr Index) was up 0.81% over the month. The yield curve flattened as the spread between long-term and short-term bond yields narrowed. 3-year government bond yields ended the month down 10 basis points (bps) while 10-year government bond yields were down 12 bps to 2.52%. Short-term bank bill rates ended the month lower. The 1-month rate was down 2 bps to 1.86%, the 3-month rate was down 1 bp to 1.95% while the 6-month rate was also down 1 bp to 2.14%. The Australian dollar closed the month lower at USD 0.72.

During the month, the Reserve Bank of Australia (RBA) maintained the cash rate at 1.50%. The RBA continues to maintain its view on the economy, with global growth continuing and global inflation remaining low.

Domestic economic data releases were mixed in August. Employment retraced in July following the massive surge in June, falling by 3,900 positions. Meanwhile the unemployment rate fell unexpectedly to 5.3%, the lowest rate since November 2012. The NAB Survey of Business Conditions eased to +12 in July, while business confidence rose 1 point to +7. Retail sales exceeded expectations, rising 0.4% in June. Building approvals were below consensus, falling 5.2% in July.

Australia Market Outlook

Despite signs of improvement in key global economies, we remain cautious, given ongoing geopolitical risks and shifting central bank policy settings. The European Central Bank reduced the pace of their QE tapering, with the program set to end in December. Concerns remain around the fragility of Europe following on from Italy's new populist government and Germany's coalition becoming divided on immigration policy. Meanwhile, the signing of a pledge between North Korea and the US towards peace including denuclearisation of the Korean peninsula was met with a muted market reaction. The US instigated trade war remains ongoing, as the US continues to impose new tariffs, and targeted countries continue to retaliate.

The Australian economy continues to grow and has officially completed 26 years of uninterrupted expansion. We expect the monetary policy easing that took place in 2016 to continue to support a slow but robust growth environment.

Over the past six months, the consumer has struggled despite a strong business and employment outlook. Corporate profits are robust and business confidence is high, however historically low retail sales and poor consumer confidence driven by very low wages growth makes the outlook for growth in 2018 quite mixed.

We expect the RBA to continue to keep rates on hold into 2020. In the bond market, we expect Australian bond yields to follow global yields higher. Provided there is no sharp sell-off in risk assets we would expect credit spreads and swap spreads to remain well supported.

Credit Commentary

Credit continued with the weakness of the previous month but Australian spread moves were quite restrained with an outward drift of about 1 bp overall. Spreads in the synthetic Australian iTraxx tightened 1 bp while US CDX and European iTraxx widened by 2 bps and 8.5 bps respectively.

August was the reporting month for many Australian corporates and overall results were reasonably healthy. Rio Tinto, Transurban, Aurizon, Origin Energy, Woolworths, Qantas and Caltex all reported improved profits. Wesfarmers and Tabcorp also were positive but with more complicated results due to asset divestments. Telstra continued to highlight its competitive pressures with a decline in EBITDA.

The Australian REITs also reported strong results with Mirvac, Vicinity, GPT, Stockland, Dexus and Goodman all reporting profit increases. Foreshadowed asset sales (particularly for Vicinity) create a degree of doubt for future performance and the recent benefits from the compression of cap rates is not expected to continue to support these profits.

In other issuer news, at the start of the month, Apple was the first company to break through the trillion US dollar market capitalisation mark. Later in the month, it was announced that Transurban had been approved by the ACCC for its WestConnex acquisition.

Credit issuance for the month was AUD 12.9 billion, the highest monthly amount since July 2009. Supply was largely financials, with two Canadians banks (Bank of Nova Scotia and Bank of Montreal) providing over AUD 3 billion of issuance. However, non-financial issuance also reappeared with Optus, Macquarie University and Toyota accessing the market. The securitised market saw AUD 3.3 billion of issuance with two

RMBS deals (SMHL and Sapphire), one ABS (CHN) and one SME CMMBS (Liberty).

Credit Outlook

After recent widening, credit spreads are now closer to their post-financial crisis historical average levels across most jurisdictions and sectors, although still on the tighter side. At these spreads, any global or economic uncertainty will create increased widening pressure and the recent uncertainty is putting pressure on spreads, but underweighting credit for any sustained period of time has become more expensive as spreads widen.

Despite a two month hiatus in June and July, supply in Australia has been strong both in the financial and non-financial sectors, though this was met with increased buying especially from Asia, which constrained spread widening at this stage. Future domestic non-financial supply is, however, always uncertain, given many Australian investment-grade issuers tend to be low-geared and so require less debt. In addition, the bank loan market remains attractive for shorter maturities and offshore markets offer competitive pricing for sizable long-term debt issues. Many issuers have also taken advantage of low rates to refinance much of their maturities and the short-term corporate pipeline is thin.

Offshore, supply in the US market has remained strong despite a relatively quiet July and offshore markets are, in general, not as exposed to the lack of supply of non-financials as the Australian market.

Given the relative tightness of spreads, caution needs to be applied especially when investing in lower-rated credits. Despite the differing performance in terms of ratings, high-yield spreads are reasonably tight and the extent of compensation for taking exposure to lower-rated credit is less compelling.

Our preferred sectors remain domestic or select Asian banks, RMBS and the higher-rated utilities corporates, both domestically and in Asia or the US. Select offshore banks can also provide strong opportunities but caution must be taken due to the difficult operating environments and regulatory uncertainty for banks in many jurisdictions.

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