Australian Fixed Income Monthly
December 2020

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Australian market commentary

The Australian bond market (as measured by the Bloomberg AusBond Composite 0+ Yr Index) returned -0.27% over the month. The yield curve steepened as 3-year government bond yields ended the month flat at 0.11%, while 10-year government bond yields rose by 7 basis points (bps) to 0.97%. Short-term bank bill rates were largely unchanged. The 1-month rate was 1 bp lower at 0.01%, the 3-month rate was also down 1 bp at 0.01%, while the 6-month rate was steady at 0.02%. The Australian dollar was up sharply, closing the month at USD 0.77.

The Reserve Bank of Australia (RBA) maintained monetary policy settings in December after having delivered a rate cut and additional measures to support the recovery at its November meeting (where the cash rate was cut from 0.25% to 0.10%, as was the thee year yield target). The parameters of the Term Funding Facility and the government bond purchase program were also maintained in December.

Domestic economic data releases in December were mostly upbeat. Employment rose by 90,000 positions in November, which exceeded market expectations. The unemployment rate ticked lower to 6.8%, which was also better than expected. The NAB Survey of Business Conditions showed improvement, rising to 9 in November, and is now at above average levels. Business confidence also improved, rising to 12. Retail sales were up 1.4% in October. National CoreLogic dwelling prices saw a third consecutive monthly rise in December, ending the month up 1.0%, and closing the year 3.0% higher.

Australian market outlook

December saw continued hope for both the Australian and global economies as COVID-19 vaccines were rushed to market. However, question marks remain about how quickly any vaccines will be rolled out and the willingness of the population to be early adopters of a new vaccine.

Despite a severe contraction in Q2 GDP which saw Australia enter recession, the downturn is not as severe as previously expected and a recovery appears to be under way. The RBA has updated its economic forecasts as a result, with expectations of 5% GDP growth in 2021 and 4% growth in 2022. Unemployment is expected to peak closer to 8% in 2021, rather than the 10% previously expected. Inflation is expected to remain subdued, at 1% in 2021. We believe there could be upside risk to the inflation forecast, given recent increases in commodity prices and rising house prices which are being supported by record low interest rates.

The RBA remains committed to its current policy settings and has repeatedly stated that it is not expecting to increase the cash rate for at least three years. Lower interest rates should assist the recovery through lower financing costs for borrowers, a lower exchange rate and support for asset prices and balance sheets. The Term Funding Facility is also supporting the supply of credit to businesses.

The Australian economic outlook is highly dependent on how well COVID-19 will be controlled. Assuming the vaccine roll-out goes to plan, we expect a moderate economic recovery as many lead indicators have now turned positive, including business conditions, global PMI, employment indicators, lending statistics, retail sales, house prices and commodity prices. The key risk to the recovery is a stop/start economy if for any reason the vaccine roll-out does not go to plan. Other risks include the early withdrawal of government stimulus if the data continues to look rosy. This includes the impact on small businesses when JobKeeper ceases and the end to JobSeeker, both expected at the end of March. From an external standpoint, the lack of international visitors and students also weighs on the outlook for the local economy, as does the trade war with China.

Credit commentary

The news cycle in December was dominated by President Donald Trump's continuing refusal to concede his US election loss and the launch of trial-approved vaccines to deal with the worsening COVID-19 pandemic in North America and Europe. After more than 50 court cases initiated by President Trump's supporters being lost mainly due to lack of evidence of voter fraud, the Electoral College confirmed Joe Biden as president-elect in mid-December (Mr Biden will be sworn in as president on 20 January 2021). The US has approved two vaccines developed and successfully trialled by Pfizer/BioNTech and Moderna. The UK has also approved the vaccine developed and trialled by Astra Zeneca. The US, UK and a number of other countries have now commenced vaccination programs, with expectations it will take until late 2021 or 2022 before a substantial proportion of their populations are vaccinated.

In Australia, there was an outbreak of community transmission of COVID-19 in Sydney in late December with over 100 people now infected. The shutting of intra-state borders is likely to have some impact on confidence as this outbreak coincides with annual summer school holidays. At this stage, the Australian government has not approved any vaccines, with rollout of Pfizer and Astra Zeneca vaccines expected to commence in March if the vaccines are approved in the short term.

Barring any major worsening of the local community outbreak in Sydney, it is expected that Australia's economic conditions are likely to improve given the imminent rollout of the vaccine and the absence of community transmission in other states, albeit with some impact on the tourism-related sectors given the closed borders. This general optimism is reflected in continuing tight credit spreads following strong performance last month.

In early December, Westpac announced that it entered an enforceable undertaking with APRA over its risk governance remediation. Under the agreement, Westpac will submit an integrated remediation plan within 90 days, and then report quarterly to APRA on its implementation. It was also reported that ASIC has opened another case into misconduct at AMP regarding alleged breaches of its financial services license and (financial planning) audit failures.

APRA announced that it was reviewing the capital framework that applies to Approved Deposit Institutions (ADIs) to embed the "unquestionably strong" capital support, improving flexibility and enhancing completion. As part of the review, APRA wants to align the Australian framework more closely with the international Basel 3 standards. The new framework will apply from 1 January 2023.

In mid-December, APRA announced that from the start of 2021, it will no longer cap bank dividend payments at half of their settings (50% of statutory profit), saying the onus will now return to bank boards to make decisions on sustainable dividends. APRA said this decision was made after taking into account an improvement in the economic outlook, strengthening of bank capital and provisions levels and a recommencing of repayments by a majority of loans previously granted repayment deferral. The dividend decision was also supported by the results of APRA's stress testing of bank portfolios in a post-COVID-19 world under severe downside conditions. While higher dividend payouts are likely, APRA still wants the banks to remain cautious on payouts, taking account of the economic environment and outlook at that time.

December is typically a quiet month for issuance. There were seven credit issues in December totalling AUD 3.05 billion. Financial issuers included Macquarie Bank, Met Life and AMP Life. Non-financials included two universities—Western Sydney University and University of Wollongong—in addition to NBN and one of Goodman's wholesale industrial property funds, GAIF.

Total credit issuance for 2020 was about AUD 60 billion, down c.26% from AUD 80.7 billion in 2019. Issuance by financials during 2020 totalled about AUD 43.9 billion, well down on previous years of AUD 66.9 billion and AUD 65.8 billion in 2019 and 2018 respectively. This was mainly due to subdued market issuance by the four major Australian banks during 2020 given their build-up of deposits and access to the low-cost Term Funding Facility (TFF) from the RBA. In contrast, non-financials issuance was notably higher in 2020 as both domestic and foreign issuers sought to access local demand on attractive terms, with total non-financials issuance of about AUD 16.1 billion compared with AUD 13.8 billion in 2019 an AUD 8.6 billion in 2018.

There were four securitisation issues during December totalling AUD 2.9 billion: RMBS issues by ME Bank's SMHL and Resimac's Premier program (totalling AUD 2.0 billion) and ABS issues by Peeper's Sparkz program and Metro (totalling AUD 916 million).

Ratings news in December was dominated by Standard and Poor's (S&P) lowering the rating of the State of Victoria by two notches from AAA to AA and lowering the rating for the State of New South Wales by one notch from AAA to AA+. The action was attributed to revenue losses from COVID-19 and large countercyclical spending in response to the pandemic. A few days later, Moody's placed its Aaa rating for the State of Victoria on review for downgrade. Credit markets were wary that downgrades of these two major states may also lead to a downgrade of Australia's sovereign AAA rating, which in turn would likely result in downgrades for banks and government agencies. S&P subsequently commented that no rating on a state or territory impacts the sovereign rating.

Issuers to receive new ratings during December included GAIF Bond Issuer (rated Baa1 by Moody's) and Credit Union SA (also rated Baa1 by Moody's).

Credit outlook

After a contraction of spreads since March, and further step-down in November which has held at similar levels in December, credit is less compelling.

As noted previously, while Australia has done well to contain the community spread of COVID-19, the level of economic activity is still in recovery phase, helped by substantial federal and state Government support programs. The local optimism of a path forward given gradual relaxation of social restrictions and potential vaccines in the near future, is still somewhat clouded by the unknown impact of expected run-off in these various government support programs and the recent resurgence of infections in both the US and Europe. Caution has become a key requirement for viewing markets. For credit investors, understanding the different risks involved in individual credit issuers has become increasingly pertinent as an initial broad-based spread widening has now been almost completely reversed and spread movements have become increasingly refined depending upon the exposure of each issuer to the COVID-19 affected areas of the economy.

The funding costs for issuers is likely to remain low as investors search for yield, supporting new issuance and refinancing. Markets remain cautious on sectors and names that are more COVID-19 impacted, such as airlines and airports. Spreads have tightened over time for more COVID-19 resilient issuers and sectors such as utilities, non-discretionary retail (e.g. supermarkets) and industrial REITs.

Both overall supply and demand were lower domestically in 2020 from the previous year, but supply has been assisted by local non-financial issuers being more willing to access the domestic market. However, going forward until at least markets settle and outcomes from virus-related restrictions become clearer, it would seem likely that supply will be uncertain. Domestic non-financial supply is traditionally less abundant and is being tempted to offshore markets where government buying of credit has strengthened both the demand and pricing of credit.

Given that the RBA's TFF will limit the need for local financial supply, 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 to 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, the airport and airline sectors should be viewed cautiously but even the less immediately exposed issuers must be scrutinised very carefully for indirect impact from any protracted delay in the local economic recovery. Securitised product 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.

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