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# AUSTRALIAN FIXED INCOME MONTHLY

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## Australia Market Commentary

The Australian bond market (as measured by the Bloomberg AusBond Composite 0+ Yr Index) was up 1.50% over the month, outperforming Australian equities which fell 0.12%. 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 16 basis points (bps) to 1.85% while 10-year government bond yields were down 27 bps to 2.32%. Short-term bank bill rates ended the month higher. The 1-month rate was up 17bps to 2.05%, the 3-month rate was up 9 bps to 2.09% while the 6-month rate was up 9 bps to 2.22%. The Australian dollar was lower, closing the month at USD 0.71.

During the month, the Reserve Bank of Australia (RBA) maintained the cash rate at 1.50%. The RBA maintains its view that the Australian economy is performing well and that while the global economy is still expanding there are signs of a slowdown in global trade. Further progress in reducing domestic unemployment and a return to target inflation is also expected, albeit gradual.

Domestic economic data releases were mixed in December. The Australian economy grew by only 0.3% over Q3 2018, this was much weaker than the expected 0.6%. The Australian Treasury released the Mid-Year Economic and Fiscal Outlook (MYEFO), with the underlying budget deficit of AUD 5.2 billion as expected. Employment rose by 37,000 positions in November (mostly in part-time positions). Meanwhile the unemployment rate rose from 5.0% to 5.1%. The NAB Survey of Business Conditions eased 2 points to +11 in November and business confidence fell 2 points to +3.

## Australia Market Outlook

Global growth has desynchronised and we remain cautious given ongoing geopolitical risks and shifting central bank policy settings. The US Federal Reserve raised the federal funds rate by 25 basis points in December and the European Central Bank ended its QE tapering program. The US instigated trade war remains ongoing, despite the temporary truce called between the US and China at the last G20 Summit.

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 remains positive, however historically low retail sales and poor consumer confidence driven by very low wages growth makes the outlook for growth 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

With news flow on trade wars, oil price falls, Brexit and the partial closure of the US Government, credit continued to suffer from uncertainty in the less liquid December market leading up to the festive season. Spreads widened severely in the US by approximately 18 basis points (bps), slightly in Europe by approximately 2 bps and in Australia by nearly 8 bps. Synthetic indices also reflected this widening with the Australian iTraxx 12.5 bps wider and, in offshore markets, the US CDX 12.5 bps wider and European iTraxx 6.5 bps.

In issuer specific news for the month, Coca Cola Amatil's share price fell 12% after announcing it would divest SPC and also suggesting it would miss its earnings growth targets. While it had no immediate ratings impact, the ongoing woes for the company suggest underperformance. The Queensland Competition Authority released its final decision which saw Aurizon's revenue capped at AUD 4.12 billion which is AUD 230 million higher than the March draft ruling but still AUD 770 million less than Aurizon's proposal. The Australian Competition and Consumer Commission deferred its decision on the TPG-Vodafone merger

over concerns on the impact on competition and is now requesting a further submission in January before making a ruling in March.

The Reserve Bank of New Zealand introduced a new additional 6.5-7.5% Tier 1 Capital buffer to be implemented by May 2019. This requirement will impact the big four Australian banks given they all have New Zealand subsidiaries.

In ratings news, Qantas and Mirvac both dropped Standard & Poor's (S&P) as a rating agency. In both cases, the ratings from S&P was lower than other available ratings – in general, Nikko regards such decisions with considerable caution. In other rating news, Anheuser-Busch InBev was downgraded from A3 to Baa1 with a stable outlook due to its high debt balance and also being behind on expectations regarding its deleveraging. S&P moved Macquarie Group's outlook to 'Positive' from 'Stable' on its BBB rating while moving the outlook on Macquarie Bank Limited to 'Developing' from 'Negative'.

Following AUD 12.6 billion issuance in November, December saw a very low AUD 100 million of supply (from one issuer, Bank of Queensland). The total non-financial corporate issuance for 2018 was AUD 9.2 billion, about half of the previous year's supply. Financial issuance increased to carry the total amount issued for 2018 to AUD 75.1 billion up from 2017's AUD 74.1 billion. In securitisation, two deals were priced, both having substantial pre-commitments: a Liberty auto ABS and a National Australia Bank RMBS.

## Credit Outlook

Credit spreads continued to widen, though still substantially tighter than the levels of 2015. As such, there is room for further widening in an environment where global or economic uncertainty continues to apply pressure: however, underweighting credit for any sustained period of time has become more expensive as spreads widen.

Supply in 2018 exceeded that of the previous year, boosted by strong issuance from the major banks and other financials. Domestic non-financial supply is, however, always uncertain given many Australian investment-grade issuers tend to be lowly 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 and offshore markets, are in general, not as exposed to the lack of supply of non-financials as the Australian market.

Given the weakness 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 in the US still appear reasonably tight and in Europe are close to normal but vulnerable to further widening; as such, 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 stronger utilities. 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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