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FROM THE FIXED INCOME DESK

Australia Market Commentary

The Australian bond market (as measured by the Bloomberg AusBond Composite 0+ Yr Index) was up 0.16% 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 up 3 basis points (bps) while 10-year government bond yields also rose, up 2 bps to 2.65%. Short-term bank bill rates ended the month lower. The 1-month rate was down 14 bps to 1.88%, the 3-month rate was down 15 bps to 1.96% while the 6-month rate was down 7 bps to 2.15%. The Australian dollar remained unchanged in July, closing the month at USD 0.74.

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 strengthening and global inflation remaining low.

Domestic economic data releases were generally better than expected in July. 2Q CPI came in at 0.4%q/q with the fuel price rising markedly at +7%q/q. Employment surged in June with 51,000 positions added. Meanwhile the unemployment rate was steady at 5.4%. The NAB Survey of Business Conditions rose to +15 in June (previous +14), while business confidence fell to +6 from +7. Retail sales rose a higher than expected 0.4%. Building approvals surged 6.4% in June, far outpacing the consensus of 1.0%.

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 2019. 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

Sentiment improved over the month of July on the back of positive reporting from the US, although concerns over the US-China trade war remained. Somewhat against the more positive trend, Australian physical credit markets were slightly weaker again in July with spreads drifting about 2 basis points (bps) wider. Offshore markets stabilised during their summer lull. Synthetic credit spreads were volatile but finished the month tighter. The Australian iTraxx narrowed 7 bps compared to 8.5 bps for the US CDX and 11 bps for European iTraxx.

At an individual issuer level, apart from rating changes, news was largely confined to US reporting which was broadly positive. Aside from Wells Fargo which is still suffering from its fake account scandal, the major US banks were all above consensus with Bank of America being particularly impressive with net income up 12%. Domestically, Aurizon/Pacific National had their intermodal asset sale blocked by the ACCC.

July was a month of mostly positive rating actions: BNP Paribas was moved to positive outlook at Standard and Poor's (S&P); ING Bank was moved to positive outlook at Fitch; Rio Tinto was upgraded to A/stable at Fitch, bringing them in line with S&P; RBS Group was upgraded at Moody's to Baa2/Positive and RBS Plc moved to a positive outlook; Banco Santander was upgraded to A/stable at Fitch; and QBE Insurance Group was taken off negative watch and its A- rating was affirmed at Fitch, Ford Motor Company, however, bucked the positive trend being moved to negative outlook by S&P.

Credit issuance this month was relatively subdued, although up from May's AUD 1.75 billion to AUD 5.3 billion. This was largely due to several large three-year issues from ANZ (AUD 2 billion) and RBC (AUD 1.7 billion). Non-financial corporates were conspicuously absent from the Australian primary market for a second month. The securitised market saw AUD 2.1 billion

of issuance in three RMBS deals: Pepper, Triton and a refinancing of a CBA Medallion tranche.

Credit Outlook

By post-financial crisis standards, even despite recent widening, credit spreads are still below post-financial crisis historical average levels across most jurisdictions and sectors. With these lower spreads, any global or economic uncertainty will create increased widening pressure and recent uncertainty is putting pressure on spreads. However at this stage credit markets are still benefitting from positive factors, such as a technical bid for credit due to the search for yield in a reasonably low-yield environment, supportive policies by some central banks, acceptable domestic corporate balance sheets and a low likelihood of major bank failure. This mix of positive factors and market nervousness results in a relatively neutral view on the direction of spreads.

Up to May, supply in Australia had been strong both in the financial and non-financial sectors but this was met with increased buying especially from Asia which has constrained spread widening at this stage. Future 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 many 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 much 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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