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Since 1889

Fixed Income Monthly

Australian Government Bond yields			
Name	Coupon	Price	Yield
2 Year	1.75	99.37	2.05%
5 Year	5.50	113.80	2.25%
10 Year	2.25	100.16	2.73%

Bank Bill Swap Rates—18/10/2018	
30 Day	1.85%
90 Day	1.93%
180 Day	2.09%

RBA Cash Rate		
Effective Date	Change	Rate
02 October 2018	0.00	1.50%

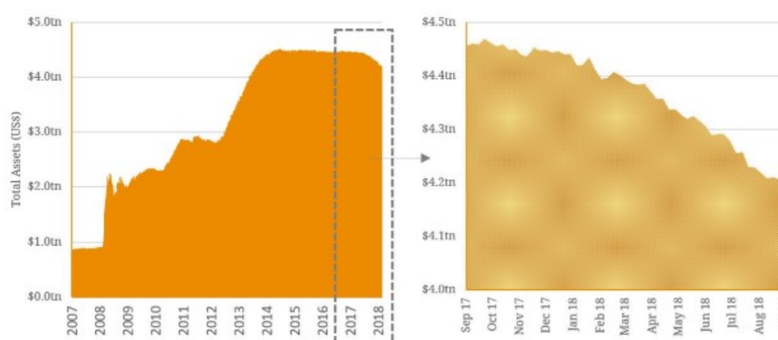
Cash Term Deposit Rates			
Name	3m	6m	12m
Adelaide Bank	2.40	2.58	2.65
ANZ Bank	2.60	2.57	2.57
Macq. Bank	2.50	2.55	2.60
Bank of Melb.			2.69
ME Bank	2.70	2.85	2.75
Nat Aust Bank	2.61	2.62	2.66
St George Bank	2.25	2.40	2.55
Bank of Qld	2.00	2.55	2.65
Comm. Bank	2.45	2.60	2.75
Westpac Bank	2.00	2.15	2.35

Quantitative tightening: What's happening 12 months on

Quantitative easing (QE) was first pioneered by the Bank of Japan (BoJ) way back in 2001, when it was employed as a stimulative economic policy after the BoJ ran short-term rates down to zero. QE's mechanism for stimulation is the purchase of debt securities by central banks (in the secondary market), causing the central bank's reserve supply to increase and subsequent heightened liquidity, allowing lenders to pass on credit to companies and households. Quantitative tightening (QT) is the mirror image of QE, whereby central banks allow these purchased securities to mature without replacing them. This reduces monetary supply within the financial system and means the Treasury must find new buyers of government debt. Given these massive asset purchases (QE) drove up the price of assets, it stands to some logical reason that doing the opposite (QT) would likely have the reverse effect in the market.

Following the global financial crisis (GFC), in October 2008 the US Federal Reserve (Fed) attempted to revive the flow of credit by rapidly employing QE and purchasing bonds. The Fed continued to purchase bonds up until 2014, albeit also branching out to purchase other assets including US$1.8 trillion worth of mortgage-backed securities (MBS), which represented over a quarter of the MBS market, in addition to swaps and overnight loans of securities.

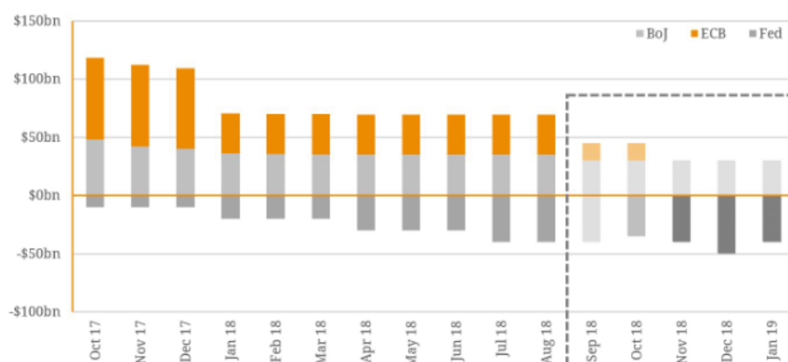
Fig 1: Total assets of the US Fed; Long term (LHS) and month-on-month (RHS)



Source: BondAdviser, St Louis Fed

Under the previous Federal Reserve chair, Janet Yellen, it was announced that QT would begin on 1 October 2017 under the guise of policy normalisation arising from the strength of the US economy. Since then, current Fed chairman Jerome Powell has been rather scathing of QE, stating it is a "habit forming" policy that increases moral hazard; whereby investors take on more risk with the knowledge that the Fed will backstop losses. Other Fed officials have echoed similar sentiment that large bond holdings are distorting financial markets, prompting investors to be less risk-averse than they otherwise would be.

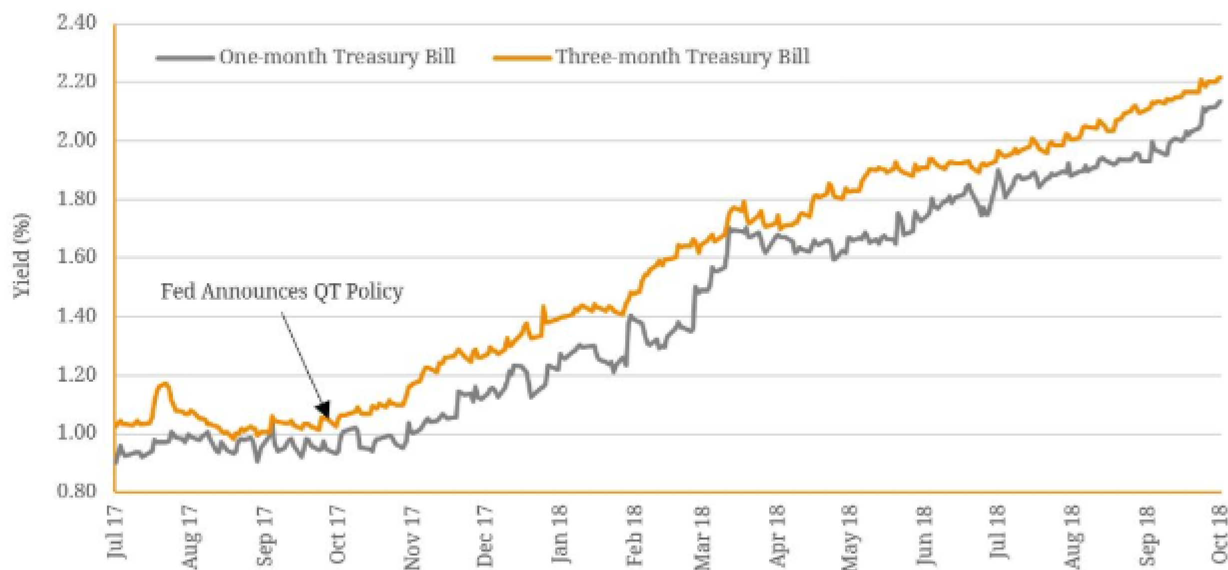
Fig 2: Net asset purchases for the C-3 banks are forecast to decline further in 2018



Source: BondAdviser, Bloomberg Intelligence, Bloomberg Economics

Since QT began a year ago, the Fed's total assets balance has declined by 6.3%. This maiden anniversary has also coincided with the Fed balance sheet falling below US$4 trillion for the first time since 2014. On average, throughout 2018 the total asset value held by the Fed has fallen by US$5.1 billion per week. More recently, ramping up of QT has seen US$40bn of bond holdings mature per month without replacement, which has significantly restricted money market supply. On a global scale, the combined C-3 central banks – the Fed, European Central Bank (ECB) and BoJ – have seen their balance sheets increase by US$76 billion in the first half of the year (1H18) compared to US$703 billion in the preceding half (2H17). In other words, more than US$500 billion dollars of liquidity has effectively gone missing from global markets in a relatively short space of time.

Fig 3: Yields on short-term Treasury Bills have been on the rise over the last 12 months



Source: BondAdviser, Bloomberg

Although presented to investors as being a slow and gradual policy, the QT process has agitated markets (with greater volatility compared to "Goldilocks returns" in 2017). Furthermore, market commentary regarding QT has been broadly negative, with some analysts labelling QT as the primary driver of asset-class performance throughout 2018. Figure 3 shows the rapid rise in short-term Treasury bill yields, amplified by further issuance by Treasury, which in turn has propagated strength in the US dollar.

In terms of a normalised balanced sheet, the Fed still has some way to go before it reaches that point. Contractionary pressures of higher interest rates alongside sustained QT will require a robust market to pick-up the shortfall of central banks. As credit tightens and asset prices fall, central bankers need to be wary that the illiquidity nexus that spawned QE may rear its head again, however this time it would be through QT.

Month in Review

September

Suncorp confirms redemption of all Suncorp Subordinated Notes
Suncorp Group (SUN) confirmed it would redeem all Suncorp Subordinated Notes (SUNPD) on the optional redemption date of 22 November 2018. Each holder will receive the face value of A$100 plus the final interest payment of $1.2111 for each note held on 14 November 2018. The last day of trading on the ASX will be 12 November 2018.

IOOF Holdings wraps up ANZ OnePath purchase
IOOF Holdings (IFL) recently completed its purchase of ANZ's OnePath life insurance business. The $975 million sale was announced in October 2017, as Australia's major banks have looked to divest their life insurance assets over the last 12-18 months.

ANZ also recently announced that its FY18 cash profit will be impacted by additional charges relating to customer compensation and accelerated amortisation of software and other items. In total, $374 million of provisions have been recognised in 2H18 for customer compensation, whilst the bank also noted $104 million of restructuring charges and $55 million of external legal costs relating to the royal commission.

ANZ is due to announce its full year results on 31 October 2018.

Aurizon reaches new agreement for intermodal business
Aurizon (AZJ) recently announced that it has a reached an agreement to sell its loss-making Queensland intermodal business to trucking group Linfox for $7.3 million, after having a previous $20 million joint venture deal with Linfox and rival Pacific National blocked by the ACCC. After the deal was blocked Aurizon signalled its intention to shut down the business before the ACCC launched a lawsuit against the freight company in July that resulted in the Supreme Court enforcing an injunction on the company to keep the intermodal business in operation until it could be sold.

The deal is subject to Supreme Court approval following the injunction, but if successful will result in Aurizon incurring a $35 million pre-tax loss. Assuming final approval, we view this as overall credit neutral for the group despite it likely being able to dispose of the loss-making segment.

Coles demerger
Wesfarmers (WES) announced the date of the Scheme Meeting to be held for Wesfarmers shareholders to vote on a scheme of arrangement for the proposed demerger of Coles. The Scheme Meeting is currently slated to occur on the 15th of November in Perth following the conclusion of the conglomerate's AGM.

Upon successful approval of the demerger, Wesfarmers shareholders will be eligible to receive one Coles share for every Wesfarmers share they currently hold. The conglomerate is still expected to retain a 15% stake in Coles in addition to its 50% stake in its flybuys loyalty program.

Whilst sporting a robust balance sheet and strong cash generation profile, the demerger of the Coles business should provide Wesfarmers with enhanced agility, as the supermarket chain currently comprises 60% of the group's deployed capital but generates only 34% of its earnings.

Furthermore, the demerged Coles entity will take with it secured committed bank facilities of ~$4.0bn and carry ~$2.0bn of net debt. Wesfarmers intends to use its newfound flexibility to shift its investment weightings towards businesses with strong future growth prospects, and whilst we typically view such expansionary behaviour as credit negative, we do foresee any well-executed acquisitions to be credit neutral as they should be supported by strong cash flow generation that will enable the group to maintain a robust investment grade credit rating.

Wesfarmers also announced that Coles has entered into a Heads of Agreement with Witron Australia to develop two new ambient distribution centres over the next five years. This is a commitment for the Coles business and should not have any bearing on Wesfarmers once the demerger of the business is complete in November 2018.

18 October 2018

Baillieu Holst
Since 1889

Research Report—ANZ Capital Notes (ANZPD)

Issuer Name

ANZ

Security Name

ANZ Capital Notes (ANZPD)

Security Recommendation

Hold

Security Risk

Upper Medium

Issuer Outlook

Improving | **Stable** | Deteriorating

Key Characteristics

Product Type	Capital Note
Issue Size	$1,120mn
Last Price	$101.68
Par Value	$100.00
Running Yield	5.48%
Yield to Maturity	5.32%
Trading Margin	3.03%
Fixed/Floating	Floating
Payment Frequency	Semi Annual
Current Distribution	5.54%
Issue Margin/Coupon	3.40%
Franking Credits Included	Yes
ASX Code	ANZPD
Convertible	Yes
Capital Price	$101.01
Optional Call Date	01/09/2021
Next Ex Date	20/02/2019
Next Payment Date	01/03/2019
Next Cash Distribution	$1.90

On the 7th of August 2013 ANZ Banking Group Limited issued ANZ Capital Notes (ASX Code: ANZPD) raising $1.12 billion. These securities are perpetual, unsecured, convertible, transferable, redeemable, subordinated notes. The purpose of this transaction is it will be treated as additional Tier 1 capital for regulatory purposes. The interest margin is set at 3.40% p.a. above the 180-Day BBSW and distributions are fully franked, floating rate, preferred, non-cumulative, subject to payment conditions and paid on a semi-annual basis in arrears.

This security has no fixed maturity date but is scheduled for mandatory conversion into ANZ ordinary shares on the 1st of September 2023, subject to the conversion conditions being satisfied. At the issuer's discretion, and subject to approval by APRA, the notes may be redeemed/transferred or converted on the 1st of September 2021. As this security meets the new capital instrument eligibility criteria under Basel III it also contains the loss absorbing terms and conditions known in the documentation as Capital and Non-Viability Trigger Events. Upon the occurrence of these events this security will be converted into ordinary shares without the protection of conversion conditions.

Recommendation—HOLD

While the security is Hold rated, we believe they are expensive on a relative basis when compared to its peers.

From a credit risk perspective (that is uncertainty surrounding the stability of the credit profile) ANZ's strong earnings capacity, capital buffers and prudent risk management systems mitigate downside risks for capital investors. Any significant change to the capital price is more likely to be driven by market supply imbalances and/or larger prudential and economic changes such as potential changes to the regulatory framework as advised in the financial system inquiry. In our opinion, the changing regulatory landscape is a credit positive for all Tier 1 instruments including potential increase in capital requirements, lending constraints and higher risk weights. While these changes may not be welcomed by shareholders they should reduce inherent credit risks if deployed in an orderly manner.

Our valuation assumptions for this security are based on the security being redeemed (in full) on the optional exchange date (1 September 2021 or ~4.3 years) and all interest payments being made in full in a timely manner. If this security is not called on this date (extension risk) the price of the security may fall. From a valuation perspective, there are a number of comparable securities in our universe which give us confidence in our valuation.

Risk of events such as a Common Equity Trigger Event conversion (or write off) are common across 'new style' Tier 1 securities, but we consider the probability of such an event for ANZ to be remote in the current environment. Investors should note these terms make the return profile asymmetric (unlimited downside but limited upside) and in all likelihood, its performance will have a higher correlation to equities than a traditional fixed income instrument during a period of stress. The most likely scenario for a breach of these triggers would be either (or a combination of) a significant and sharp deterioration in the asset quality of residential mortgages (which would impact all banks) or a failure of risk management within an institution that would lead to significant losses. If these events are triggered they are likely to cause a significant capital loss to the investor. All of these factors have been considered in our recommendation.

For our full report please click here.

Money Markets

The month of September presented us with many of the same recurring themes, namely the ongoing US-China trade war rhetoric and another rate rise from the US Federal Reserve. The Fed raised the Federal Funds Target Rate by 25 bps to lie within the 2.00-2.25% range. Whilst this move was widely anticipated, the FOMC omitted the word "accommodative" when describing its monetary policy stance, implying that the Fed Funds rate may be moving towards more "neutral" territory and normalising rates.

Furthermore, US Federal Reserve Chairman Jerome Powell stated that the inflationary impact of a tight labour market was "greatly reduced, not eliminated". This is significant, as it indicates the Fed's belief that inflation is largely contained, and it sees no need to aggressively raise rates. This may provide some relief domestically, as it eases the rising funding pressure costs on authorised deposit-taking institutions who have announced out-of-cycle rate hikes over the past few months.

Domestically, the RBA continues to hold the overnight cash rate at 1.50%, while Commissioner Kenneth Hayne released a scathing interim report from the royal commission. It made recommendations including better enforcement of the law by regulators and a simplification of those laws to assist them in doing so.

Comparing term deposit rates

Short-term rates (~3 months) remained relatively steady across the board in September, as ANZ continues to offer the lowest rate at 1.35%. All other banks were flat at 2.00% as there remains little marginal benefit in the short-term segment given historically low rates.

The majority of the movement in the past month has been in the medium term (~6 months) segment, where the WBC special offer expired and its best rate reduced by 40 bps. BOQ continues to offer the highest rate by 20 bps over its nearest competitor (BEN), whilst ANZ was the lowest at 1.50%.

In the long-term (~12 months), ANZ offers little value at 1.50%, reflecting a lack of term premium offering from the bank. All other banks kept long-term rates on hold, as the RBA looks increasingly unlikely to raise rates over the next 12 months. BOQ offers the highest rate in this segment with 2.70%, although NAB is arguably better value at 2.60%, +30 bps over its other Big Four peers.

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Glossary

Accrued interest - Interest deemed to be earned on a security but not yet paid to the investor.

Asset backed - A bond or note backed by loan paper or accounts receivable other than mortgages.

Bond - A debt instrument, similar to an IOU. It is a contract between the borrower (issuer) and the lender (bondholder). The issuer pledges to pay the loan principal to the bondholder on a fixed date (maturity date) as well as a specified rate of interest during the life of the bond.

Call - The repurchase of a bond by its issuer before its maturity date, without requiring the holder's consent. If a bond is callable, the date and price at which it can be called is specified on the certificate.

Corporate bond - Also known as '**credit**'. A bond issued by a corporate entity.

Coupon - Also known as '**interest**'. Annual payout the borrower promises to pay the bondholder during the life of the bond. It is expressed as a percentage of the bond's par value.

Credit rating - Designations used by credit rating agencies to give relative indications of credit quality.

Credit risk - The risk of loss to an investor due to an issuer's non–payment of interest or principal on a bond.

Duration - Duration is an important measure of risk in bond investing. It measures the impact of a 1% change in yield on the price of a bond.

Face value - Also known as '**maturity value**', '**par value**', '**principal**' and '**redemption rate**'. The amount a bond or note will pay at maturity.

Floating rate note - A bond for which the interest rate is adjusted periodically according to a predetermined formula, usually linked to LIBOR.

Hybrid security - A security that combines two or more different financial instruments. Hybrid securities generally combine both debt and equity characteristics.

Issuer - An entity which issues and is obligated to pay principal and interest on a debt security.

Liquidity - A measure of the relative ease and speed with which a security can be purchased or sold in the secondary market at a price that is reasonably related to its actual market value.

Maturity date - The date when the principal amount of a security is payable.

Money market - Market for short–term debt securities with a maturity of one year or less, and often 30 days or less.

Offer - The price at which a seller will sell a security.

Over the counter market - A securities market that is conducted by dealers outside the ASX - otherwise known as the unlisted securities market.

Premium - The amount by which the price of a security exceeds its principal amount.

Running yield - It refers to the annual payout as a percentage of the current market price you actually pay. For example, a bond with a current market price of $1,000 that pays $80 per year in interest would have a current yield of 8%.

Tier 2 - Tier 2 hybrid bank securities are one notch higher in the capital structure of Australian banks than Tier 1 securities . Whilst still a hybrid security with some equity-like features , Tier 2 securities are more like debt securities because interest payments are mandatory (i.e a missed coupon payment will cause default and determine the issuer non -viable) . They also have a defined maturity date. Tier 1 securities on the other hand are perpetual securities (no fixed maturity just a call date) and issuers can miss a coupon payment. Issuers of Tier 1 securities must keep their capital ratios above 8% otherwise these securities may be converted into equity in times of balance sheet stress. At the end of the day both Tier 1 and 2 securities are subject to non–viability of the banks.

Yield - The annual percentage rate of return earned on a security. Yield is a function of a security's purchase price and coupon.

Yield curve - A line tracing relative yields on a type of security over a spectrum of maturities ranging from three months to 30 years.

Yield to maturity - A yield based on the assumption that the security will remain outstanding till maturity.

18 October 2018

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