Curve Securities 10 — Elevating performance for 10 Years

MAY 2020 INSIGHTS

A Big Unknown Hanging Over the Outlook

HIGHLIGHTS

- The focus is quickly shifting from the containment of Covid-19 to winding back the containment measures and opening up the economy.
- Monetary policy remained unchanged over the month with the RBA remaining "committed to do what it can to support jobs, incomes and businesses".
- In their quarterly Statement on Monetary Policy the RBA revealed their latest forecasts as well as other scenarios.
- Given the unprecedented nature of recent events, there is considerable uncertainty over the outlook with the RBA facing a great unknown.

RATES RECAP

- The RBA left the cash rate and its yield curve target unchanged in May, reiterating that "the Board will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2–3% target band."
- While the cash rate target is 0.25%, the actual cash rate fell from 0.17% to 0.14% driven by the ongoing excess of liquidity currently in the system.
- BBSW continued to drift lower with the 3 months rate falling 11bp to 0.10% while the 6 month rate fell 18bp to 0.15%.
- The curve has finished the month a little steeper with the three year rate continuing to hover around the RBA's target of 0.25% while the 10 year rate drifted a little wider.

Key Market Moves

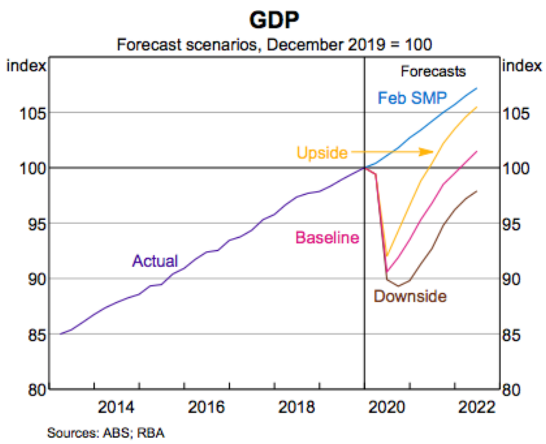
	Latest	1 Month Ago	Change
Cash Rate Target	0.25	0.25	0.00
Cash Rate	0.14	0.17	-0.03
3M BBSW	0.10	0.21	-0.11
6M BBSW	0.15	0.33	-0.18
1 Year Swap	0.13	0.27	-0.14
3 Year Swap	0.23	0.39	-0.16
5 Year Swap	0.44	0.62	-0.17
3 Year Futures	0.24	0.27	-0.03
10 Year Futures	0.96	0.89	0.06
AUD	0.65	0.64	0.02
ASX 200	5461	5387	74
US 2 year	0.16	0.23	-0.07
US 10 year	0.69	0.72	-0.03
US 30 year	1.40	1.34	0.06
USD Index	99.73	99.52	0.21
Dow Jones	24331	23719	612

- Credit spreads continue to drift lower as investors chase yield further out the curve. With issuers reluctant to issue significant volumes in the short end, long end spreads are expected to continue to decline as excess liquidity is absorbed.
- The AUD has remained very volatile again in April. After the sharp sell off in March and subsequent rebound it has continued to rise along with other risk assets in April. policy measures and the Fed has re-opened USD swap lines that haven't been used since the GFC.expected impact on the outlook.

A Big Unknown Hanging Over the Outlook

Australia can once again count itself as one of the lucky ones. We were one of the few nations that avoided the worst of the Global Financial Crisis. It also appears now that we will be one of the lucky countries who has managed to flatten the curve when it comes to the Covid-19 virus. We have so far avoided widespread infections and our death toll is remarkably low.

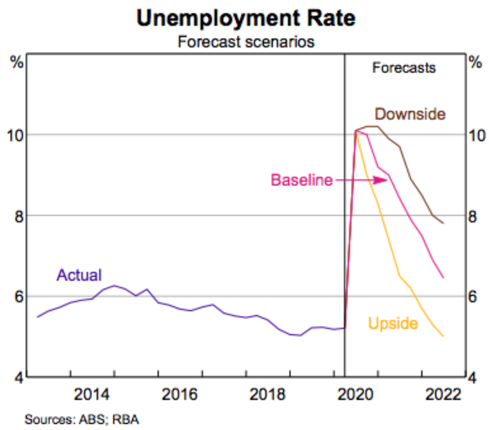
With the peak of the virus now past us, much of the focus is on slowly rolling back the containment measures and getting the economy back up and running. The latest data releases are giving us a glimpse into the impact that fighting the virus has had. Some of these numbers are significant and difficult to comprehend.



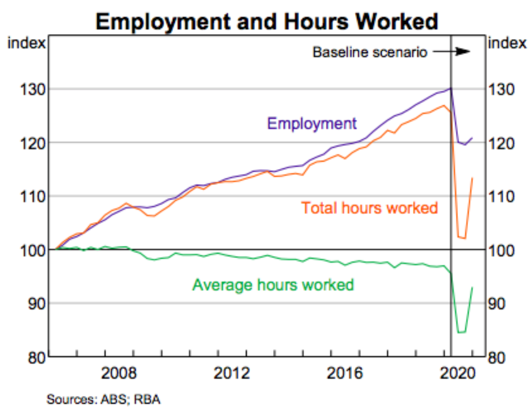
What we are seeing is the impact of an economic event the likes we have never experienced. We have had recessions before, as part of the usual business cycle. We also have data on experiences from previous pandemics. However, we have never seen such an interconnected global economy all but shutdown so suddenly, without warning and little time to prepare. That is what makes anticipating what will happen next so difficult.

We have seen economists producing numbers on what the impact of the lockdown will be and how the outlook may evolve once the economy starts to reopen. Last week it was the RBA's turn to give us their latest forecasts and how they see the outlook evolving.

Much of their outlook hinges on the coming months with the RBA saying that *"beyond the first half of 2020, the outlook for the domestic economy depends on how long social distancing remains in place and its effects on economic activity."*



The RBA sees the economy falling by 6% over the course of 2020, with a large contraction in the June Quarter, before growing by 6% in 2020. The economy is expected to then grow by 5% the year after. Unemployment is expected to spike to around 10% before easing back next year to around 7% and inflation will undershoot the target band for the duration of the current forecasts to June 2022.



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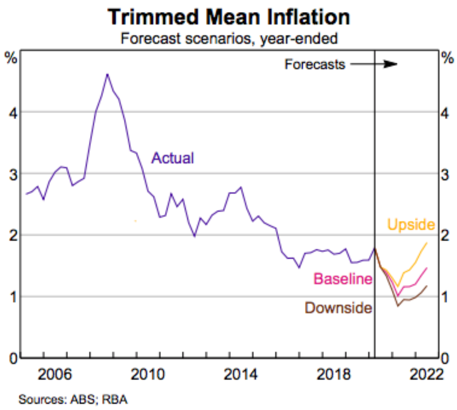
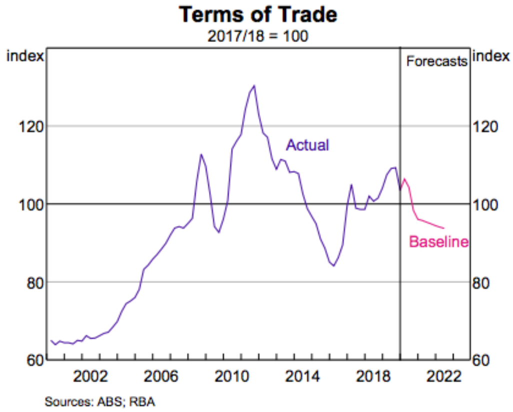


As a result of this uncertainty, the RBA has also given upside and downside scenarios and articulated the variables that could contribute to the range of outcomes they have described. Even under the range of scenarios, we could still see something different all together.

Part of the problem is that the RBA does not know what the broader behavioural consequences that the events of the past few months will have going forward, saying:

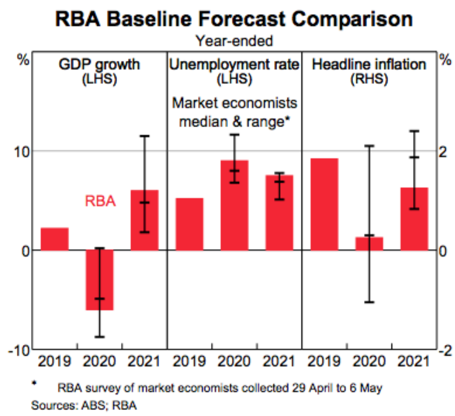
"It is quite plausible that the current economic disruption will



We saw that despite avoiding the worst of the Global Financial Crisis, consumer behaviours in Australia changed. We saw a marked shift in the growth rate of household consumption in the decade that followed and that was even after avoiding a recession. It is highly unlikely that things will bounce back to be exactly how they were prior to the virus spreading around the globe.

We are likely to see a lower appetite for leverage. Increased household savings to create a buffer in the household budget. Greater transition to working from home and flexible working structures. Meanwhile some other trends like reduced retail foot prints and online marketplaces will accelerate even quicker. There are many more subtle ways behaviours will change.

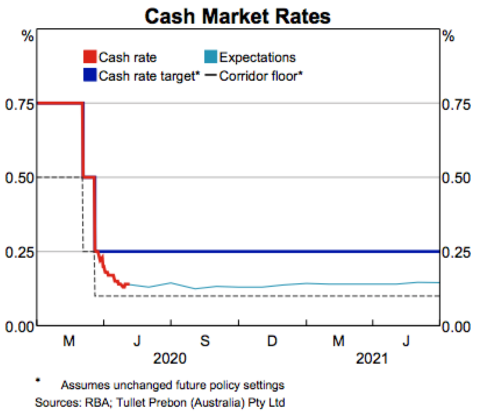
It is all those things that contribute to the big unknown for the RBA, other central banks and governments around the globe. While they can provide the preconditions for the economy to grow and life to return as close to normal, they can't anticipate the behavioural changes that will reshape how businesses and consumers make decisions once the virus has past. It is these changes that will shape the outlook for years to come.



Outlook for interest rates

Last week we heard from the RBA twice. First we got the post meeting statement from their May Board meeting and then we got their more detailed Quarterly Statement on Monetary Policy. On both occasions, they reiterated that their current stance on monetary policy is unlikely to change any time soon. They made clear that:

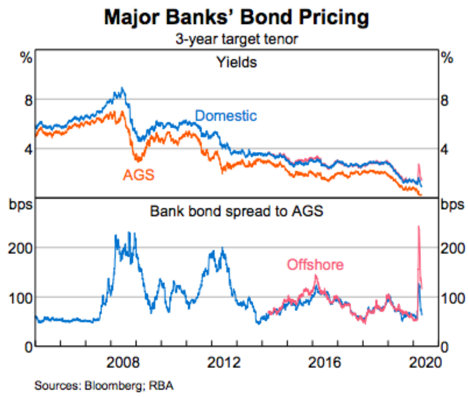
"The Board will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2–3 per cent target band. The Board is committed to do what it can to support jobs, incomes and businesses during this difficult period and to make sure that Australia is well placed for the expected recovery."



If we take that statement and overlay it with the RBA's forecasts, it suggests that the current setting of monetary policy will be with us for some time.

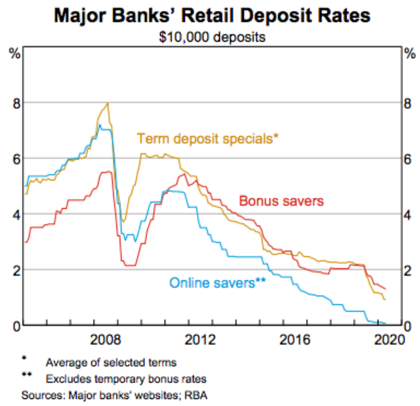
The RBA is currently forecasting inflation will be anchored below the 2-3% target band for the entirety of the forecasts period out to mid 2022. Even under the RBA's upside scenario, the annual rate of underlying inflation doesn't make its way back into the target band over the forecast periods. Based on their forecasts, we might not see inflation 'sustainably' within the target range for 3 to 4 years.

Full employment is also one of the RBA's mandated duties. The RBA now expects the unemployment rate will reach 10% over the coming months and will remain above their expected level of full employment for the duration of the forecast periods. Under the upside scenario, the rate of unemployment will only reach pre-crisis levels by mid 2022.



So we are unlikely to see the RBA's current calibration change anytime soon. Interestingly, the RBA expect the actual cash rate will also remain under their target for the duration of the forecast period. The actual cash rate continues to hover above the rate the RBA pays on Exchange Settlement balances. The RBA expects it to remain around that level.

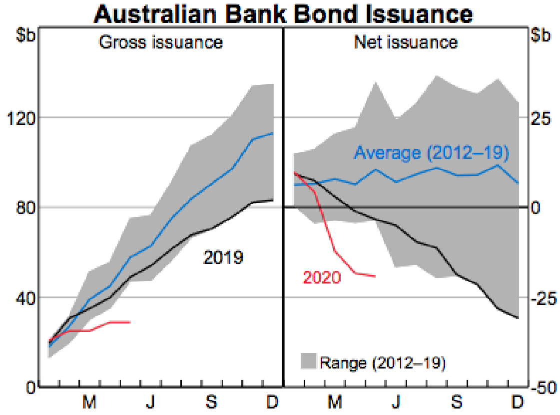
The abundance of liquidity in the system, represented by around $60bln in surplus exchange settlement balances, is largely responsible for the cash rate being pushed below the target band. It is also having an impact on other rates in the market.



While short dated reference rates such as BBSW are falling towards the cash rate, other rates are also falling. Swap rates are falling. So are bond spreads and even term deposit rates. With little demand for new funding at present, this is likely to continue.

The sharp reduction in borrowing rates is also resulting in outstanding loans being paid back quicker than would have otherwise been the case. Without enough new lending to offset these repayments, banks don't require additional funds to sustain new lending. That has also seen a significant fall in the amount of bank bonds on issue.

Overall, we are likely to see longer term interest rates continue to drift lower over the coming months. This could change over time as the economy starts to reopen and the government starts to ramp up its borrowing activity that will be required to fund all of its new expenditure measures.



Sources: Bloomberg; Private Placement Monitor; RBA

Australian Economic Highlights

- Growth ticked up slightly in Q4 for 2019 printing at 0.5% for the quarter bringing the annualised rate to 2.2%. Despite an indication that growth may be at a gentle turning point recent events could see large changes when Q1 data arrives.
- Inflation was largely in line with expectations in Q1. Headline inflation rose 0.3% taking the annual rate to 2.2% while the trimmed mean was up 0.5% with the annual rate edging up to 1.8%. Prices are expected to fall in Q2; however, core inflation is expected to remain positive.
- Job loses as a result of the shutdowns weren't captured in the March Employment data due to the timing of the survey. Total employment growth was 5,900 which saw the unemployment rate edge up to 5.2%. The market is expecting the April figures to show that 550,000 jobs were lost in April taking the unemployment rate up to 8.3%.
- ANZ Job ads report fell by a record 53.1% in April, almost 5 times the previous biggest fall seen in the survey since its inception. While the number of jobs ads has stabilised over the past couple of weeks, the true test will be when the economy starts to re-open to see how many new jobs will be available for those who have lost theirs as a result of the shutdowns.
- Business confidence rebounded in April after the disastrous March reading. The index is up 19 points to -46 however is still twice as week as the trough seen during the 1991 recession. Business conditions fell heavily in April with large falls seen across every sub-component. The fall in the employment index and capacity utilisation are of significant concern with NAB saying it "could well see further restraint on business investment going forward."
- As was flagged by the weekly consumer sentiment reports, Consumer confidence fell sharply in April with the index falling by 17.7% to 75.6. What was surprising was the sharp move around expectations pertaining to the housing market. This poses a big risk to the outlook given how critical housing is to the performance of the broader economy.
- Retail sales benefited from the huge demand for food ahead of the lockdown with supermarket sales soaring. It saw retail sales post a massive 8.5% gain in March. Despite the bounce, sales volumes for the quarter were still only up 0.7%. Sales figures for April are expected to be much weaker.
- Housing finance was mixed in March as the virus containment measures ramped up. Owner occupier finance continues to increase while investor credit continues to decline. Falling housing turnover could see new housing finance slow sharply in the months ahead.
- Australia's trade surplus ballooned to a record $10.6bln in March as exports surged 15% and imports fell 4%. The huge surplus will help offset the smaller surpluses in January and February and will add to growth for the quarter.
- Building approvals eased back in March, falling by 4% which was slightly better than expected. While multi unit dwelling approvals remain volatile, private housing approvals remain soft.