RBA Recap

- QE was extended to February at the rate of $4 billion of purchases a week
- The August meeting minutes acknowledged the limits of further monetary policy easing during lockdowns. This signals the RBA will likely maintain or reduce further QE purchases rather than increasing them.

Markets Recap

- APRA ended the use of the CLF by the end of 2022, which will have implications for bond yields.
- There were a range of primary bond issues over the month, including by a major bank and semi government entity.

Investing Considerations

- The CLF changes will put downward pressure on government bond yields over 2022 even as QE is tapered and should increase yields on non-government bonds.
- Dollar cost averaging and averaging-in are strategies to consider in a rising interest rate environment.

Economic Summary

- Data over the last month continued to paint the picture of an economy doing well ahead of lockdowns with GDP coming in ahead of expectations and employment holding up well.
- However the impact of lockdowns is showing up in the more recent data points with business and consumer confidence down along with retails sales.

RBA Recap

Policy Decision:

QE was extended out to February at a rate of $4 billion a week. Prior to the announcement, QE was confirmed only out to November at a rate of $4 billion a week. The decision was a result of *'the delay in the economic recovery and the increased uncertainty associated with the Delta outbreak'* according to the RBA.

Many anticipated a backflip on tapering purchases, which would have meant a continued rate of $5 billion of purchases instead of $4 billion to at least November. Instead, the RBA opted to go ahead with the slight reduction in weekly purchases.

August Minutes:

For both the August and September meetings, markets had anticipated a backflip on QE tapering only for the RBA to push ahead with reduced purchases. The extension out to February is no surprise. However, if the economy had been tracking the same as pre the recent delta outbreak, the RBA may well have reduced the rate of purchases from November to February to around $3 billion a week.

The August meeting minutes signalled a shift which may explain the misjudgement of markets. In persisting with the slight reduction of purchases, the RBA said that *'fiscal policy is a more appropriate instrument than monetary policy for providing support in response to a temporary, localised reduction in incomes'*.

Whereas last year, when faced with lockdowns early in the year followed by Victoria's extended lockdown, the RBA went ahead with a raft of measures. Namely cash rate reductions, a yield curve target, the TFF and QE. With the financial system awash with liquidity, the RBA now deem that adding even more liquidity will have little effect. Therefore, assuming the economy gets back on track by the end of this year/start of next year as the RBA expects, the RBA will be more inclined to taper QE further rather than maintain or increase purchases.

The Bank of Canada could be a guide for the RBA. They first reduced purchases from a rate of $5 billion a week to $4 billion in October 2020. They maintained this rate for 6 months (the same period the RBA currently plans from September to February) before reducing the rate to $3 billion a week for 3 months followed by a reduction to $2 billion a week. In October the Bank of Canada is expected to announce a reduction to $1 billion before ending QE entirely.

Markets Recap

CLF

Key Market Moves

	Latest	1 Month Ago	Change
Cash Rate Target	0.10	0.10	0.00
Cash Rate (Actual)	0.03	0.03	0.00
3M BBSW	0.01	0.03	-0.01
6M BBSW	0.03	0.07	-0.03
1 Year Swap	0.06	0.07	-0.01
3 Year Swap	0.44	0.40	0.04
5 Year Swap	0.79	0.79	-0.00
3 Year Futures	0.33	0.39	-0.06
10 Year Futures	1.21	1.36	-0.16
AUD	0.73	0.75	-0.02
ASX 200	7552	7273	279
US 2 year	0.22	0.21	0.01
US 10 year	1.32	1.36	-0.04
US 30 year	1.96	1.99	-0.02
USD Index	92.97	92.13	0.84
Dow Jones	35102	34870	232

ADIs are required by APRA to hold a certain amount of High Quality Liquid Assets (HQLA), namely for times of severe financial stress. Government bonds, both commonwealth and state, are considered the most appropriate HQLA assets, alongside Exchange Settlement (ES) balances and banknotes.

However, prior to covid there was a lack of government bonds. If ADIs were to include only government bonds, ES balances and bank notes as their HQLA then they would own a very large portion of the supply of government bonds. Therefore, the Committed Liquidity Facility (CLF) was implemented. This allowed a broader range of assets, such as ADI bonds to be included as HQLA.

Since covid, state and federal governments have needed to spend to support the economy, which has resulted in an increased supply of government bonds. Around $962 billion and $1 300 billion of government bonds were available at the end of 2019 and 2020 respectively, which is expected to rise to near $1 400 by the end of 2021 and $1 600 by the end of 2022.

Accordingly, the CLF allowance has fallen from $248 billion in 2018 to $142 billion as of 2021. In September they announced the end of ADIs being able to include the Committed Liquidity Facility (CLF) as part of their HQLA by the end of 2022. By the end of 2021 no CLF can be included in the liquidity coverage ratio (HQLA that is used to meet short term obligations, i.e., less than 90 days).

Floating Semi Government Bonds

Even without the above CLF changes, floating government bonds are in high demand. Most government issuers prefer fixed and long-term funding, as this aligns with cash flows of their assets. Many investors though, especially ADIs, prefer floating rate investments to avoid interest rate risk.

A couple of months ago, floating semi government bonds with maturities ranging from 2022 out to 2026 were trading at negative margins. Over the month, of the little stock that was available, margins rose to be flat or even a couple of basis points. Curve alone moved around $50 million of these.

The lack of supply combined with high demand for floating government bonds are the primary contributors to low margins. As a comparison of other government bond yields, T notes are still issuing either flat or negative and the RBA still have the yield curve target of 0.10% imposed on

the April 2024 fixed bond. As of writing (13 September) NSW TCorp issued a May 2026 at +10 and a May 2028 at +19.

This margin contrasts to a February 2025 NSW TCorp trading around +2. The pickup in yield speaks to the steepening of the curve the further past 3 years investors go. However, even the primary issue margin is very suppressed.

Bond Issues

Primary bond issues have been rare since covid began. The RBA's measures to support the economy, namely the Term Funding Facility, reduced the need for ADIs to raise funding via new issues. The last month has seen a number of new issues. These include:

- **NAB** 5-year Floating Rate Note (FRN), issue margin of **+40**
- **Suncorp** 5-year FRN, issue margin of **+47**
- **Canadian Imperial Bank of Commerce** (CIBC, major bank equivalent rated by Moody's and Fitch) 5 year covered bond, issue margin of **+37**
- **ING** 5 year covered bond, issue margin of **+40**

Note: covered bonds are considered less risky as they use assets as collateral in the event of a default. Therefore, they usually have yields lower than equivalent non covered bonds.

Investing Considerations

Government Bond Yields

ADIs will need to shift at least part of their HQLA from the CLF to government and semi government bonds. Although the current CLF allowance is $142 billion, a smaller amount is expected to flow into government and semi government bonds.

NAB expect as low as $50 billion to flow into semis and government bonds, with bloated ES balances (which is included as HQLA) meaning ADIs already have large amounts of HQLA not including the CLF. Indicative of this is ADIs current liquidity coverage ratios, which are around 130%, well above the required 100%.

As ADIs buy government bonds in large volumes (at least $50 billion going off NAB's prediction) to include as their HQLA, yields should remain suppressed or even head lower. Adding to this, the RBA are expected to maintain QE for at least half of 2022, even if at lower volumes.

As a yield play, government bonds are not the place to be. With the central bank artificially lowering yields they are signalling to investors to go elsewhere, which should be ignored at investor's perils. For entities regulated to hold such assets though, continued QE and the CLF changes poses a downside risk for yields.

Such entities should consider buying government bonds earlier rather than later,
so if yields decline over 2022, they stand to make a capital gain (even if unrealised). Government bond futures fell following the announcement.

ADI Bonds

The CLF will also reduce the demand for ADI bonds. Around 60% of NAB's recent bond issue for example was purchased by ADIs. Such a bond can be included as collateral for the CLF, hence the large demand by ADIs. Without this being included as HQLA, demand for such assets will be lower, which should put upward pressure on yields.

As an entity that needs to buy government bonds, by purchasing government bonds now, it would free up space to invest in non-government bond assets during 2022. This is when upward pressure on yields because of the CLF changes will be most acute. For investors more broadly, they should weigh up whether waiting to purchase FRNs and ADI bonds closer to mid 2022 (closer to the TFF maturities) is a better strategy than investing now.

The recent issues are indicative of the low yields even for primary issues. There is every chance that these bonds begin to trade at a discount if interest rates rise over 2022. This would mean as an investor, you may be able to increase your yield by waiting to purchase such bonds or primary issues in 2022 or later.

New Issues

New issues were expected to normalise as TFF maturities near. The CLF changes will add further fuel to this, as ADIs may raise funds to purchase the required amount of government bonds.

This creates the same dilemma as discussed above – should you wait for primary issues in 2022 when yields are expected to pick up more sharply or take primary issues now as they come up?

Dollar Cost Averaging and Averaging In

Two methods to address this uncertainty is dollar cost averaging and averaging in.

- **Dollar Cost Averaging** - Purchasing fixed amounts over set intervals. For example, you may allocate $5 mill to purchase of FRNs for each quarter.
- **Averaging In** – Purchasing larger quantities at higher interest rates and lower quantities at lower rates. For example, you may invest $2 million for any major bank FRN that issues under +45, $3 million for +45-50, $4 million for +50-55, etc.

The benefits of both strategies are:

- It avoids sitting on the sidelines in perpetuity. A risk of a rising interest rate environment is trying to time the market perfectly. The current outlook is for rates to continue to rise until the TFF maturities, and beyond that the cash rate is expected to

increase. To only invest at the top of interest rates would mean potentially waiting many years before investing, over which time yield would have been missed by sitting on the sidelines.

- Prescribed rules make it easy to follow. This is again especially relevant in a rising interest rate environment, where it may be more tempting to wait for higher rates. The prescribed rules reduce the likelihood of either being too conservative in waiting for interest rates to rise or being too aggressive and investing too much at what appears to be a very attractive rate.

Australian Economy

The past month has been scattered with a mixed read of data as the impact of lockdowns start to surface. We finally got the growth figures for Q2, and it confirmed that the economy was humming along ok going into the end of the quarter before lockdowns hit. Growth beat expectations with the economy growing 0.7% after there were times when some thought we could see a negative print.

Quarterly Data

	Period	Value/Index	QoQ	YoY
GDP ($m)	Q2	$505,134	0.7	9.6
CPI	Q2	118.8	0.8	3.8
CPI - Trimmed Mean	Q2	119.0	0.5	1.6
House Prices	Q2	176.3	7.7	19.8

Employment has so far remained resilient in the face of lockdowns around half the country. The unemployment rate dipped to another cyclical low. However, we are likely to see that reverse over the coming months. The trade balance goes from strength to strength with the most positive sign an pick up in imports suggesting some undercurrent of domestic demand.

Monthly Data

	Period	Value/Index	MoM	YoY
TD-MI Inflation	August	120.06	0.0	2.5
TD-MI Trimmed Mean	August		-0.1	2.3
Unemployment Rate (%)	July	4.6	-0.3	-2.8
Total Employment ('000)	July	13,156	2.2	676.7
Full Time Employment ('000)	July	9,013	-4.2	455.6
Part Time Employment ('000)	July	4,144	6.4	220.8
ANZ Job Advertisements	August	195,995	-2.5	78.9
NAB Business Confidence	August	-5.3	2.0	7.0
NAB Business Conditions	August	14.2	4.1	14.4
NAB Employment Index	August	8.8	-2.4	10.9
Consumer Confidence	August	104.09	-4.8	16.2
Retail Sales	July	$29,779	-2.7	-3.1
Trade Balance ($m)	July	$12,117	$1,003	$7,843
Exports ($m)	July	$45,951	4.8	35.8
Imports ($m)	July	$33,834	3.3	14.4
Housing Finance Ex-Refi ($m)	July	$32,124	0.2	68.2
Housing Finance O/O Ex -Refi ($m)	July	$22,771	-0.4	58.3
Housing Finance Inv Ex-Refi ($m)	July	$9,352	1.8	98.7
Building Approvals Total	July	17,601	-8.6	21.5

More timely data releases are showing the impact that lockdowns encompassing half the population are having. Business and consumer confidence are suffering despite conditions holding up ok. The business employment index is slowly slipping. Retails sales continue to show signs of fatigue with services spending feeling the pinch of lockdown.

One interesting data point is housing finance. There is still strong demand for housing finance at the aggregate level. However there is signs of a rotation as first home buyer demand is fading and being replaced by investment demand.

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