MAY 2022 CURVE INSIGHTS

RBA Recap

- An upside surprise from Q1 inflation along with more wage increase talk from its business liaison program forced the RBA's hand at their May board meeting.
- Along with hiking rates for the first time in over a decade, the RBA is now setting a course to normalise monetary policy over the medium term to combat growing inflation pressures
- With the bulk of inflation pressures coming from the supply side, this tightening cycle will be fraught with danger as the RBA need to walk the fine line between taming inflation without tipping the economy over.
- The big question is, how high rates will go?

Markets Recap

- Term Deposit and NCD rates have surged. Reference rates are the largest driving force along with banks searching for tenor.
- Credit spreads have placed further upward pressure on investment rates.

Investing Considerations

- Due to the rapid increase in rates, investments made over the past couple of months might seem ‘underwater’.
- Tenor is an important part of a portfolio and should not be discouraged in a volatile period.
- Absolute returns should be recognised.

Economic Summary

- The economy is still experiencing increased inflation worries. Business and consumer confidence are reflecting this.
- The war in Ukraine, China covid lockdowns and recent flood events will continue to disrupt supply chains and will place further pressure on inflation prints.

RBA Recap

The Road to Higher Rates is Fraught with Danger

As the RBA lurches from one challenge to another, the task at hand becomes increasingly difficult. When the pandemic emerged and accelerated, the RBA has little choice but to throw everything at their disposal to counter the risks to the economy. This was an easy decision as the risk of doing nothing was considerably worse. They also had the option to reverse course if things turned out to be not as bad as feared.

When implementing the 5 pillars of support deemed necessary to ‘build a bridge to the other side’ as it was termed, the RBA moved to making decisions based on actual outcomes, rather than forecasts. With inflation now above the target band and rising, the RBA has started the process of normalising monetary policy. Unlike the circumstances they faced when going all in at the onset of the pandemic, normalising rates will be infinitely more challenging than just propping up the economy.

Encapsulating the predicament, the RBA finds itself in is the fact they are under fire at present from both sides. There are those saying they should have acted earlier in the face of surging inflation. Then there are those who are quick to point out they have hiked more than 18 months earlier than their forward guidance had defended for so long.

There is a fundamental reason why the RBA finds themselves in this situation. Monetary policy is a demand side policy tool. It uses the price of money to boost or suppress demand in order to smooth the business cycle and manage inflationary pressures. Usually, the economy would overheat when demand increases, leading to more jobs, lower unemployment, higher wages and thus higher inflation. Higher interest rates then suppress demand and the cycle reverses.

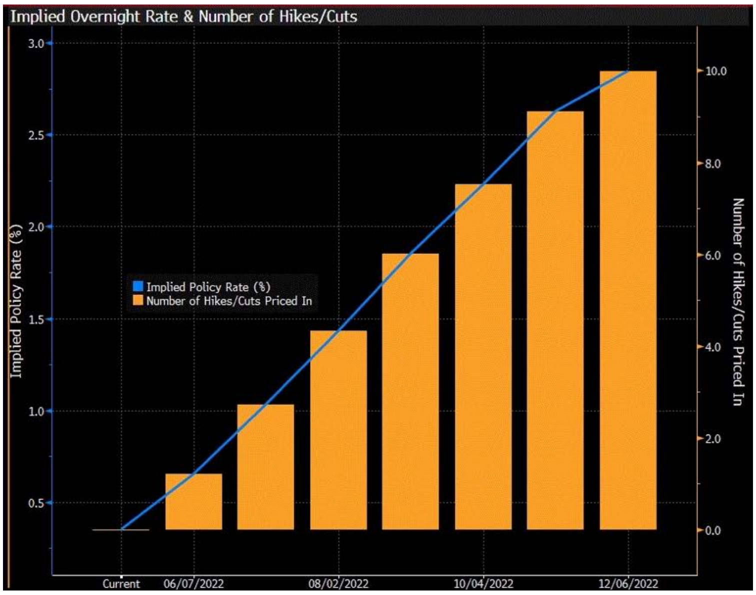
This time around the inflation pressures the economy is facing are being primarily driven by supply side issues. When the pandemic hit, governments and central banks provided generous fiscal and monetary support to their economies. With developed economies being heavily reliant on consumption, especially services, this proved problematic. With movement restrictions in place to suppress the virus spreading, consumers turned to goods rather than services to spend the windfalls of fiscal and monetary stimulus.

Such animal spirits would usually be welcomed during a pandemic; however, those restrictions used to supress the virus also had a profound impact on the ability to produce goods as well as distribute them. Fast forward two years and we find ourselves in a situation where we have an imbalance of supply and demand, which is impacting prices.

Given the unpredictability of how long it will take for the supply side issues to resolve themselves, the RBA could wait no longer and is now forced to take action. Reduced demand, all other things being equal, will reduce price pressures.

Here in lies the challenge for the RBA. They need to supress demand enough to give supply side issues time to resolve themselves to avoid an elongated period of price pressures. The longer inflation remains elevated, the more it becomes embedded and the harder it is return to a sustainable level. At the same time, they need to be careful not to hit demand too hard and choke an economy that despite its resilience during the pandemic, sits on top of a number of fault lines that could give way at any point through the normalisation journey.

For this reason, the RBA is likely to want to err on the side of caution while still showing a commitment to getting inflation back to the target band as soon as possible. As such, the outlook for the cash rate remains as uncertain as any time I can remember during my time as an RBA watcher, commentor and strategist.



In the months leading up to the RBA's decision to lift rates at their May meeting, the market had been pricing an aggressive tightening cycle over the coming 18 months. This left a wide disparity with the RBA's own outlook with most market economists predicting a path for the cash rate somewhere in between.

Markets became even more aggressive on the path of the cash rate and eventual terminal cash rate following the meeting. This may have had something to do with Governor Lowe indicating the RBA would like to get the cash rate back to its neutral level at some point. Rather than speculate on that, what we do know is the Governor also revealed the assumptions under which the updated forecasts were made had been altered.

Rather than using the current market pricing, the RBA's latest forecasts are based on a cash rate rising to between 1.50% and 1.75% with the case rate eventually settling at 2.50% in 2023. Based on that outlook, we would see a further five 25bp increases over the remaining seven RBA meetings this year and another 4 sometime in 2023. While market pricing suggests a similar pace of interest rate increases this year, it also suggests the cash rate will head considerably higher to around the 3.50% level over the medium term.

How fast and how far the cash rate goes remains to be seen. It is likely the friction point where interest rates start to have their desired effect will be clear long before the cash rate gets to levels currently priced in by the market. The optimal outcome will be a speedy resolution to the supply side issues currently dominating the outlook. This will give the RBA and market more clarity on the level of interest rates required to keep the economy on an even keel.

David Flanagan – Head of Money Markets

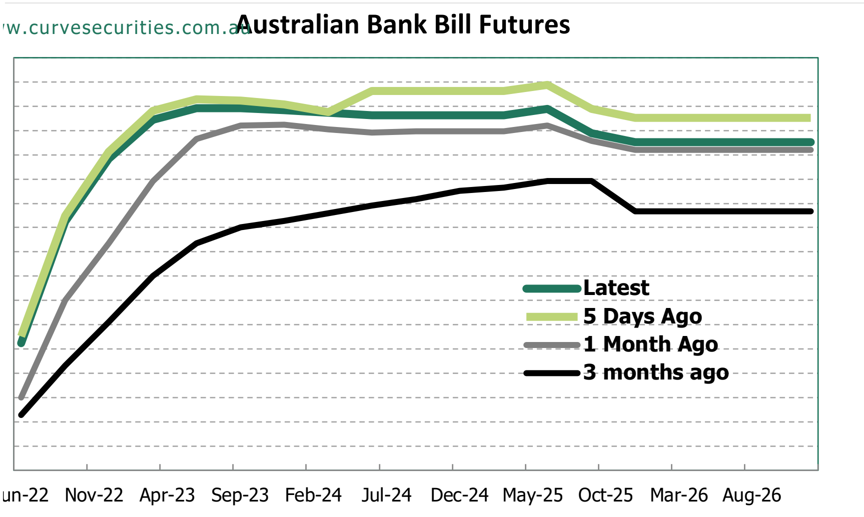
Markets Recap

Funding Dynamic

The funding dynamic has changed dramatically as the year has gone on. Over the pandemic, banks were flush with cash, after receiving close to $200b at extremely low rates from the Reserve Bank. Investors funds were being rejected, with banks not needing the funds and not wishing to pay elevated levels.

Now, we find several banks coming to market, searching for funding. With the banks having received so much funding, and with $400 billion dollars sitting in ES Accounts (Reserve Ratio Funding at the RBA) why are banks coming to market?

Most people would guess that banks require the funds to write loans. Whilst banks continue to have a large pipeline of loans to fund, this is not the sole reason.



Banks took advantage of cash accounts over the pandemic. Retail and middle market clients were lured into these products and bank saw enormous amounts of cash pour in. At the time this was of no consequence to the banks. As rates start to rise and competition for funds starts to increase, banks face the possibility of these funds 'disappearing' before their eyes. If banks continue to write loans that are several years in length, but fund themselves with short dated liabilities, the mismatch could uproot the bank. As such, ADIs have been searching for increased duration within their book, offering attractive rates in the longer tenors, and to solve this problem.

The last reason banks have come to market is to get ahead of their funding requirements. Australia has entered an interest rate rising environment. It is highly likely that funds raised today will be much cheaper than funds raised in coming months. Banks are aware of this, and wish to get ahead of the curve.

Term Deposits & NCDs

Over the past couple of months, term deposit and NCD rates have skyrocketed. Investments made at the start of March are now looking lousy. In order to understand why, we must first understand the extraordinary move within reference rates.

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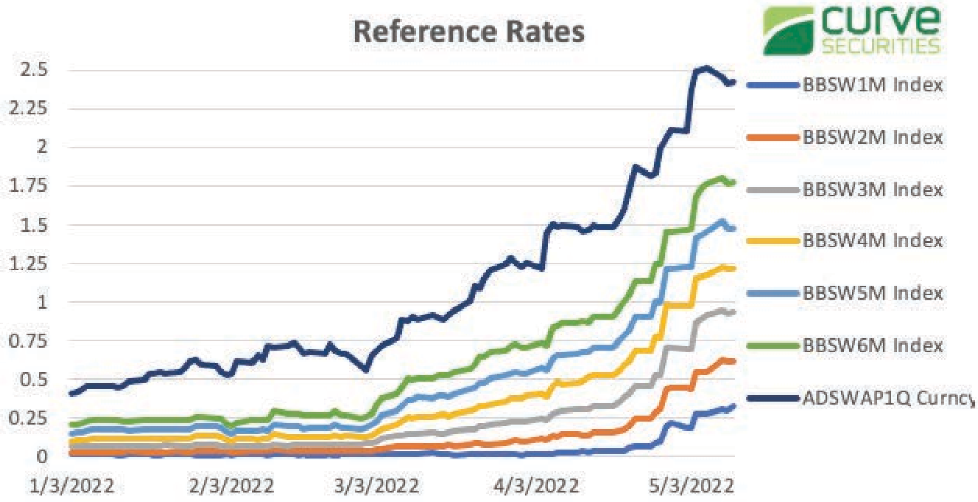
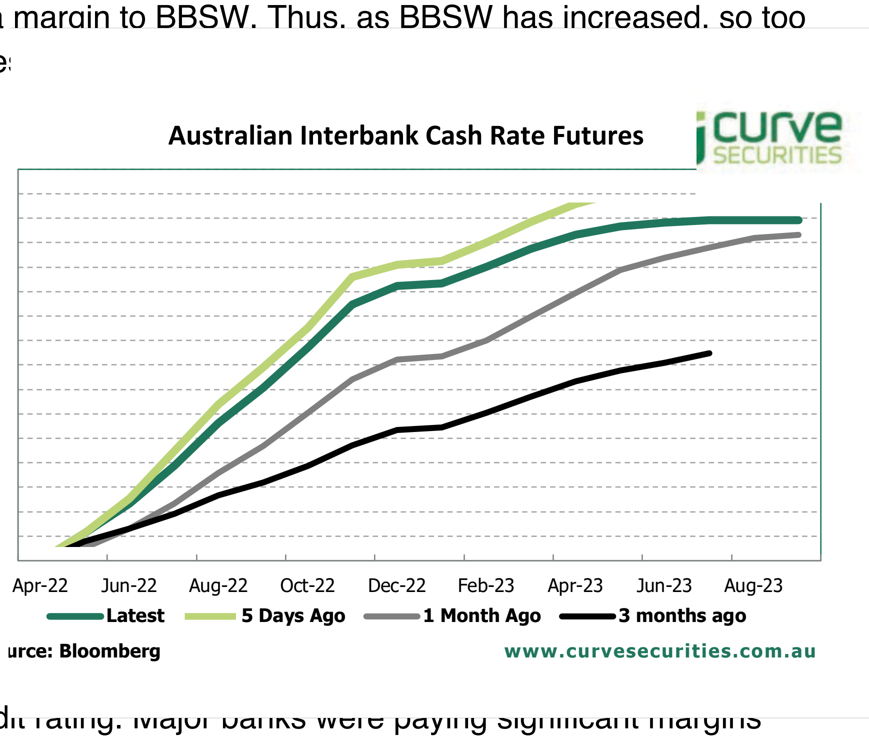
Reference rates have surged over the past 3 months. Durin the pandemic, BBSW would read something along the line of: 0.01%, 0.01%, 0.01%, 0.02%, 0.02%, 0.02% for 1 to months respectively. An exciting day saw 6-month BBSW trading around 0.12%.



At the start of the year, we have been given some relief from the extreme compression over the pandemic. However, reference rates remained terribly low.

February saw a nice relief for investors, with moderate growth in reference rates. Enter March, and reference rates exploded. Rates almost doubled in the 1Yr tenor and investors saw rates of 1% and above for a 12-month investment. Reference rates continued to rise, and rapidly, ending the month close to double where they started. Investors were receiving rates of approximately 1.80% for a 12-month investment. April saw an unprecedented level of growth within reference rates, increasing close to a percent in the longer tenors and half a percent in the shorter tenors. Investors are now able to achieve over 3% for a 12-month investment!

Term Deposits and NCDs are priced off a margin to BBSW. Thus, as BBSW has increased, so too have investment rates. Given the steepne: BBSW and 1Yr Swap being approximately 2.10%), investors have been well and truly rewarded for investing longer.

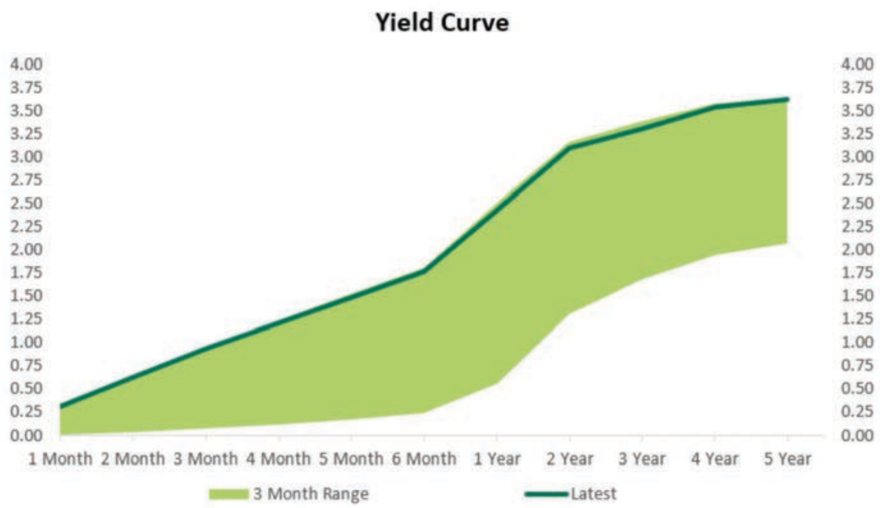


However, reference rate increases have not been the only factor at play. Credit curves have further driven ADIs to increase their rates. As discussed in the 'Funding Dynamic' subheading above, ADIs are desperate for term within their liabilities book. The major banks have been at the forefront of this search for tenor and hold the highest credit rating. Major banks were paying significant margins over BBSW to achieve the desired increase in duration. For investors to warrant investing in a worse credit, they needed to be rewarded. This placed further upward pressure on term deposit and NCD rates.

In order to completely understand the dynamic we find ourselves in, we must understand what has been driving the increase in reference rates. Interest rate expectations has been the largest contributor to reference rates. Markets have found themselves in a panic, domestically and offshore, worried about inflation running rampant through the global economy. Central banks have watched and been patient, monitoring inflation and taking a reactive rather than proactive stance. The market priced interest rate rises much earlier than central banks indicated. Reference rates are not immune to interest rate expectations and rose in response.

The Yield Curve

The yield curve has sold off dramatically over the past couple of months. Incredible selling pressure has been evident in the market as interest rate expectations drive markets. Further to this, the curve has also shifted significantly due to large sell offs within the U.S. Market.



U.S. Treasuries have sold off strongly as the Federal Reserve continues to hike interest rates amidst severe inflation pressures. This selling pressure has presented itself within the domestic market, as investors fear inflation is out of control. However, the Curve has flattened over the past month, with the market pricing highlighting more concern with front end inflation rather than long run inflation.

Central Bank rhetoric has also placed increased pressure on the yield curve. In March, the RBA announced that they were “prepared to be patient” and see all variables at play before increasing rates. In April, the RBA removed the word “patient” from their rhetoric. The yield curve shifted out in response. In addition to this, the war in Ukraine has heightened volatility of the yield curve and will continue to be a source of uncertainty.

Mark to market valuations of bond portfolios have seen significant decreases over the past month, and this is to be expected over the coming months too. Securities should be sold with extreme caution in the current environment. Conversely, floating rate notes will see more generous coupons as 3-month BBSW continues to rise.

Investing Considerations

Investment Strategy – A Rising Rate Environment

Over the past month, a few clients have said something along the lines of “I should keep this investment shorter, as I will probably get a higher rate when I reinvest”. Whilst this logic may appear to be sound, it may be flawed. Navigating an interest rate hiking cycle can be difficult, but tenor is still a major, and necessary component of a portfolio.

Given the extreme increase in term deposit rates, investors have almost become 'scared' of investing for longer terms. A term deposit placed in March may now seem to be 'underwater' and it is understood why investors may be hesitant.

However, term is an important part of any portfolio. A percentage of funds should be placed longer to take advantage of the steepness of the yield curve and the increased return. During an interest rate rising cycle, it is possible for investments to seem low after a few months. What must not be overlooked is the total return from the investment. Relative value must be observed and considered at the time of investing.

In the last 'Monthly Insights' document, break even analysis was investigated before undertaking an investment. This remains highly relevant and should be considered when making investment decisions. To read more about this, follow this link.

Australian Economy

The Australian economy enduring uncertainty from the Ukraine war, experiencing disrupted supply chains from Chinese lockdowns and recovering from severe flooding. Consequently, inflation is increasing, rapidly, and the economy is reflecting this.

Quarterly Data

	Period	Value/Index	QoQ	YoY
GDP ($m)	Q4	$521,931		
CPI	Q1	121.3	2.1	5.1
CPI - Trimmed Mean	Q1	121.1	0.7	3.7
House Prices	Q4	196.1	5.3	27.5

Headline inflation peaked at the highest rate since 2008. Core inflation broke outside of the RBA's target band of 2-3%, coming in at 3.70%. Australia had previously been sheltered from the incredible rise in inflation that other major economies had experienced. However, oil, energy and commodity prices have significantly increased over the past quarter, and are the largest source of inflation within the economy. However, given the irregularity of the data, some of these factors may have been slightly mitigated, by the government or other, so future prints may not be as drastic.

As a result, Business confidence fell 2 points over the course of April. Businesses are feeling the pain of increased input prices and are starting to push these through to consumers. Interestingly, conditions have risen. Presumably for those businesses that are situated in CBD areas, with foot traffic returning to pre-pandemic levels, and businesses who relied on tourism as appetite and ability to travel increases.

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Consumer Confidence is the lowest in 21 months (August 2020). Consumers are feeling the pain of inflation. Retail sales, despite increasing over the course of April, were also affected. This is because the retail sales data is in dollar figures, and retailers have started passing on higher costs to consumers. Moving forward, this may continue to be the case as supply chains face increased pressure due to the Ukraine War and Covid Lockdowns.

Monthly Data

	Period	Value/Index	MoM	YoY
TD-MI Inflation	April	123.39	-0.1	3.4
TD-MI Trimmed Mean	April		0.3	2.6
Unemployment Rate (%)	March	4	0.0	-1.7
Total Employment ('000)	March	13,372	77.4	49.9
Full Time Employment ('000)	April	9,228	121.9	402.7
Part Time Employment ('000)	April	4,144	-44.5	-64.6
ANZ Job Advertisements	May	242,536	-0.5	26.3
NAB Business Confidence	May	9.9	2.0	-4.3
NAB Business Conditions	May	20.1	5.2	-4.1
NAB Employment Index	May	10.0	-0.4	-4.9
Consumer Confidence	May	90.41	-5.4	-28.4
Retail Sales	April	$33,085	1.8	9.1
Trade Balance ($m)	April	$7,437	$1,877	$606
Exports ($m)	April	$49,525	7.9	23.9
Imports ($m)	April	$42,088	13.4	34.6
Housing Finance Ex-Refi ($m)	April	$32,750	-3.5	14.3
Housing Finance O/O Ex -Refi ($m)	March	$21,571	0.9	-2.2
Housing Finance Inv Ex-Refi ($m)	March	$11,707	2.9	48.4
Building Approvals Total	March	$15,183	-18.5	-35.6

Another major factor at play within the Australian Economy is the battle between fighting inflation and lifting the cash rate. As the cash rate increases, so too do mortgage rates, and more pressure on Australian households. Moreover, due to historic lows in interest rates, Australians have been heavily investing in property. Housing prices have started to decrease, perhaps showing the start of a period of negative growth. If this pattern is to continue, Australians face the very real prospect of owning negative equity within their property.

Later this month will see the latest wage growth data. It will be interesting to see any drastic moves within this space, given the tightness of the labour market. The Australian unemployment rate remains at historic lows, of 4.00%. Wages growth is notorious for being a lagging indicator, so the next read becomes more important. The downside of wages growth is that it is a double-edged sword, leading to more inflation. The upside of wages growth, is that real inflation decreases

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