

The Search for 'Safe Spreads'¹

New Zealand Fixed Income Monthly Commentary

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- The surprisingly low NZ Q4 CPI outturn removed any urgency on the RBNZ to raise official interest rates.
- The US Federal Reserve now expects to keep its official interest rate at exceptionally low levels for at least 3 years.
- Loose monetary policy and ongoing challenges in Europe are likely to keep global long-term interest rates relatively anchored.
- A widening in NZ credit spreads in the financial sector has improved their risk-return, with other sectors yet to adjust to global moves.
- With their additional security, covered bonds² issued by Australasian banks offer a possible source of 'safe spreads'.

At the height of the GFC, the expression 'search for yield' became a dirty word amongst central bankers and policymakers. It was used to describe the over-exuberance that led to the crisis, as investors piled into highly complex, highly leveraged structured products – instruments offering a pick-up in yield and endorsed by a AAA rating, but which were actually backed by toxic assets.

In addressing the GFC and ongoing wreckage, policymakers are trying to solve the problem with a new form of 'search for yield'. But, this time around, it is about deliberately keeping policy rates low and liquidity plentiful in order to encourage investors to come out of their shells by making 'safe spreads' such as plain-vanilla investments in credit look relatively attractive.

The first month in 2012 saw a continuation of this theme, with central banks strengthening their commitments to stay on hold and a widening in the yield pick-up available from credit spreads in the financial sector.

¹ The phrase "safe spreads" was coined by Bill Gross, Co-CEO and manager of PIMCO's flagship Total Return Fund. With US Treasury yields at all-time lows, it emphasises credit rather than duration risk management, including through emerging market corporates and high yielding sovereigns in non-US dollar currencies. Like all securities, even "safe spreads" are subject to investment risks.

² A covered bond is a corporate bond which the additional security of recourse to a pool of assets on the bank's balance sheet.

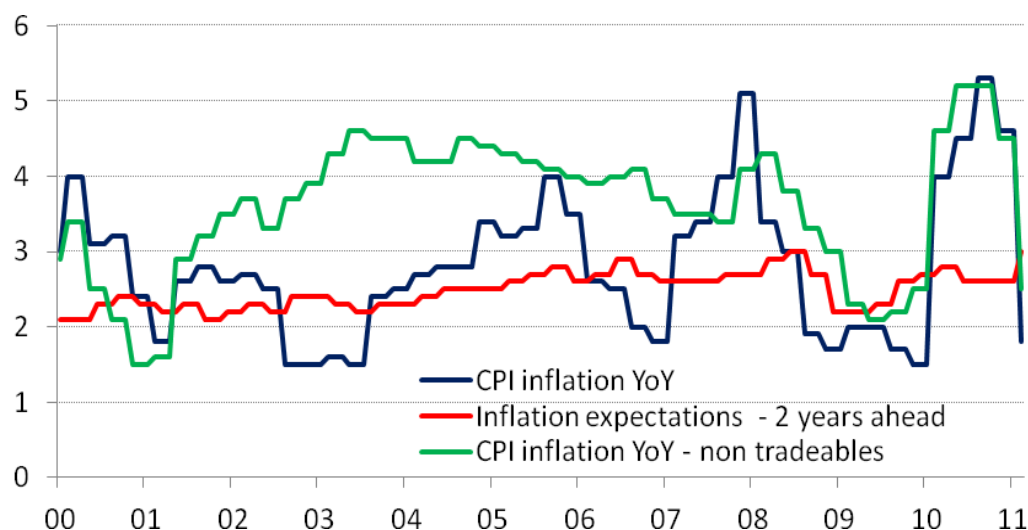
No urgency to increase official interest rates

Throughout the second half of 2011 the RBNZ kept its official interest rate on hold at 2.5%, at first as an insurance measure against the Christchurch earthquakes, and then as insurance against a deepening crisis in Europe. With NZ inflation expectations stubbornly high after the 2010 GST increase, the RBNZ had made clear that this was a temporary setting to be removed as soon as these threats had passed.

Moving into 2012, the release of the Q4 CPI outturn (Chart 1) has taken away any near term pressure to return official interest rates to more normal levels. At -0.3% quarter-on-quarter (vs +0.4% expected) and +1.8% annual (vs +2.6% expected), it was one of the biggest misses by NZ economist forecasters in many years. With inflation comfortably back in the middle of the target range, in its January review the RBNZ was able to drop the phrase “for now” from its conclusion that “it remains prudent to keep the OCR on hold at 2.5%”.

While economists debate the exact month of the RBNZ’s first rate rise, one message is clear: official rate rises are out of the conversation for at least the next six months.

Chart 1: NZ Inflation Measures

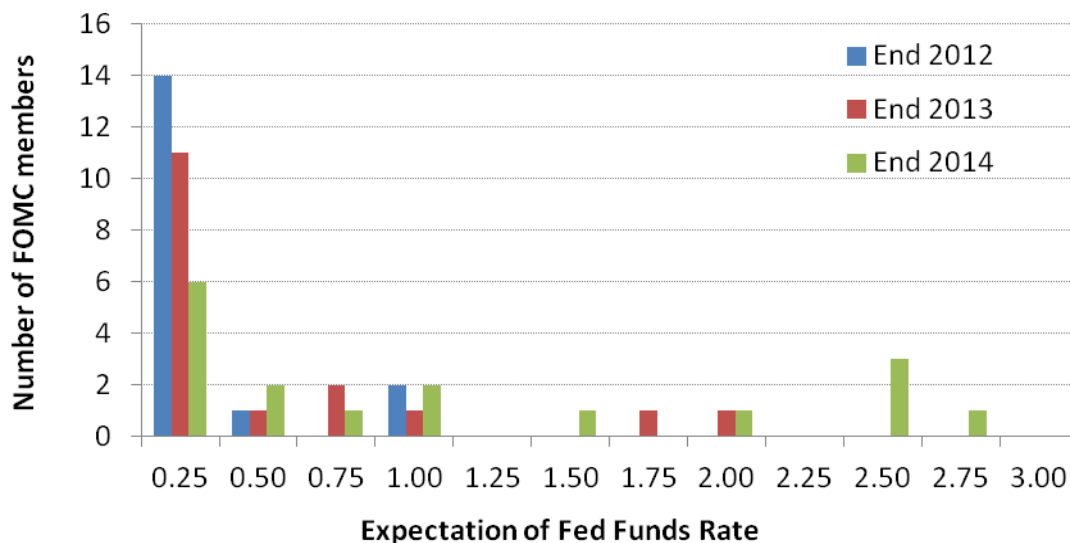


Source: Bloomberg

The US Federal Reserve reinforced this theme of official rates staying lower for longer. They now expect to keep the Fed Funds rate at “exceptionally low levels” until the end of 2014, rather than mid 2013. This adjustment in policy came as the US Federal Reserve published 3 year economic forecasts for the first time, as part of a new communications strategy.

These forecasts took a step further than other major central banks by capturing the dispersion of forecasts amongst the policy-making committee (the “FOMC”). These highlight a large variation of views by 2014, although it is almost certainly the most influential members (including Board Chairman Ben Bernanke and New Fed President Bill Dudley) making up the core of the dovish group expecting rates to be on hold for the next 3 years (Chart 2).

Chart 2: US Fed Funds Rate: FOMC Expectations

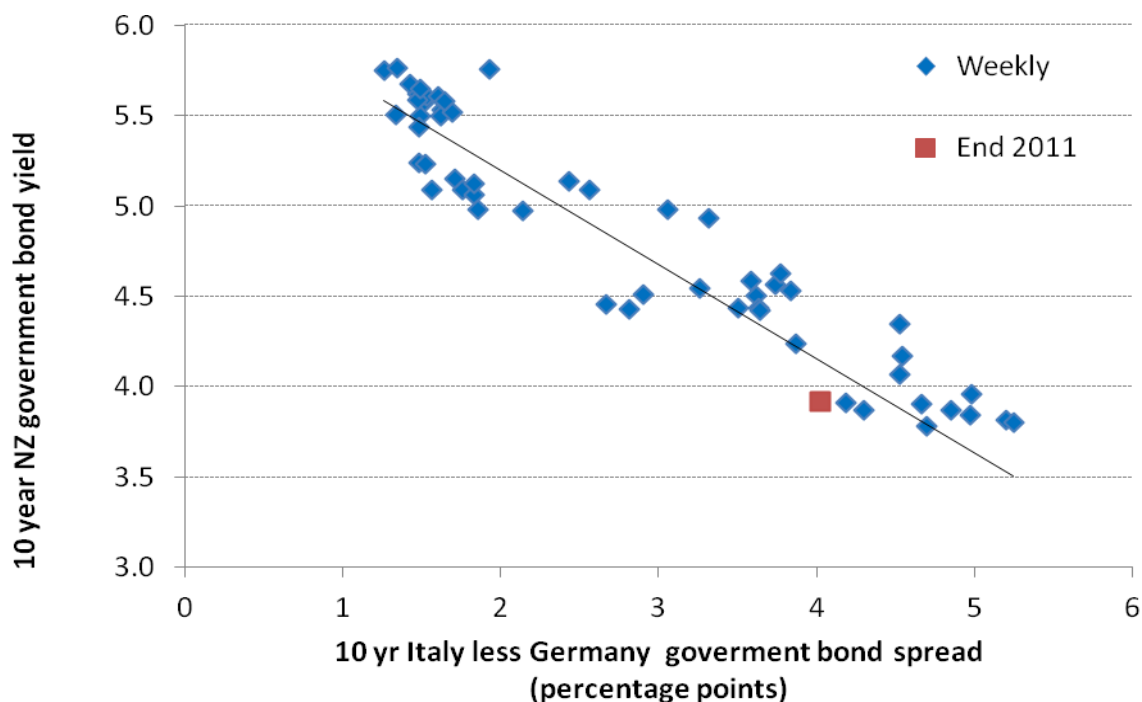


Source: US Federal Reserve

'Core' government bond yields remain anchored

In addition to loose monetary policy here and abroad, the other factor driving government bond markets has been the European sovereign crisis and the flight to safety out of vulnerable European countries into "core" countries like the US, Germany, Australia and New Zealand (Chart 3).

Chart 3: NZ 10 Year Yields vs Italy-Germany Spreads, Jan 11 to Jan 12



Source: Bloomberg and UBS

Through the course of 2011, Chart 3 illustrates that as stress in Europe has intensified (proxied by wider spreads between Italy and Germany) the yield on the NZ 10 year government bond has been driven lower by a flight to safety.

Moving into 2012, helped by plentiful liquidity from the ECB's 3 year LTROs (Long-Term Refinancing Operations), this year has started relatively well for Italy and Spain, who have seen government bond auctions well-supported and their 10 year borrowing costs falling below 6% and 5% respectively. And Greece looks close to a deal on Private Sector Involvement (PSI) in a write-down of their debt.

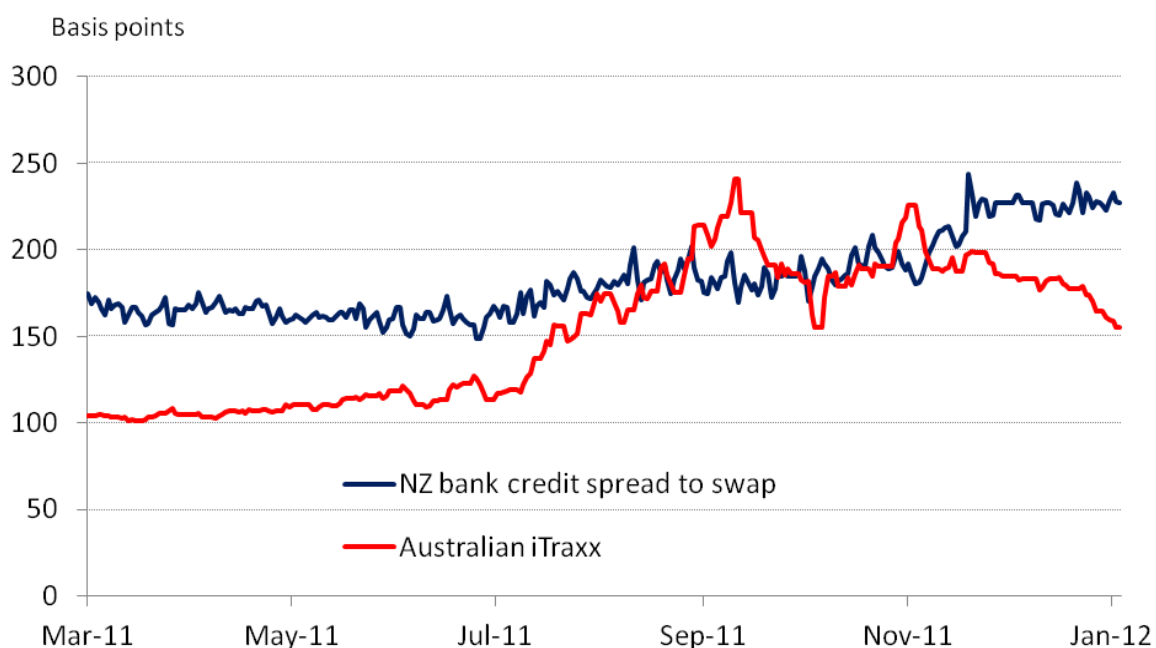
However, the environment in Europe is still very challenging. Markets remain fickle to news on Europe, and the situation in Portugal has deteriorated, with it looking unlikely that they will be able to return to private markets in 2012. More generally, weighed down by austerity measures, Europe is likely to be a drag on world growth in years to come, in an environment where the US itself is still in recovery mode from the excesses of the 2000s.

In summary, while government bond yields may head higher over 2012 from their current low levels, they are likely to remain relatively well anchored by loose monetary policy and challenges in Europe. In that environment, there are still some benefits to picking up the additional yield from longer-dated bonds.

NZ credit market offering larger premium

In response to the European sovereign crisis, global credit spreads widened over the course of 2011. This was seen most clearly Downunder through the Australian iTraxx Index, which is the best proxy for liquid, traded Australia Credit. After starting 2011 at around 100 basis points, it reached as high as 250 basis points in the second half of the year.

Chart 4: CDS versus NZ cash credit spreads



Source: Bloomberg. (NZ bank spread proxied by ANZ Feb 2018 corporate bond)

This adjustment was slower, however, in the less liquid NZD corporate bond market.

But, credit spreads for financials finally jumped wider in November, with a new long-dated senior unsecured issue pricing at around 240 basis points, which was a wider credit premium than the peak of the GFC. This process of readjustment has continued in the beginning of 2012, with two Australian banks tapping the market for large covered bond deals (A\$3bn each) at around 170 basis points, a significant widening in credit premium on these securities.

By contrast, there has still been little adjustment in the credit spreads on non-financial borrowers in the corporate bond market, with local authorities, utilities and telecoms little changed through 2011. As a result, with the financial sector further through this process of re-pricing and offering wider credit spreads, they potentially offer an improved risk-return.

The main challenge facing the Australian banking sector remains its sizeable wholesale funding needs. That said, these are becoming more manageable given the slow rate of Australasian lending growth, and some Australian banks have proved nimble at tapping global funding markets during windows of optimism on Europe.

Until conditions in Europe and global funding markets improve markedly, holding the covered bonds of Australian banks (with their additional security over senior unsecured bonds), is possibly a safer way to capture the widening credit premium available.

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