JULY 2022 CURVE INSIGHTS

RBA Recap

- Over the past two months we have seen flurry of central bank activity as the fight against inflation ramps up
- First, we saw the RBA step up its efforts to 'normalise' monetary policy by lifting the cash rate by 50bp at their June meeting.
- Then the RBA hiked 50bps for the second meeting in a row in July.
- It has many causal observers questioning what is going on and how did we get from ultra-low and accommodative policy, to central banks waging the biggest war on inflation since the Volcker years

Market Dynamic

- The last month saw a frenzy of activity as ADIs sought to firm up their position before end of financial year.
- Liquidity came at a premium for ADIs, who saw high levels of loan activity coming through the pipeline.
- Adding greater pressure on bank funding is a decrease in amortisation rates as mortgage owners have less disposable income to put towards their mortgage.
- Term Deposit and NCD rates remained attractive. Reference rates and the dynamic above were the cause.

Investing Consideration

- The current market provides investors with a fantastic opportunity to diversify their portfolio, as more ADIs start searching for funding
- Diversity not only mitigates risk but in. many cases is providing enhanced returns.

The Australian Economy

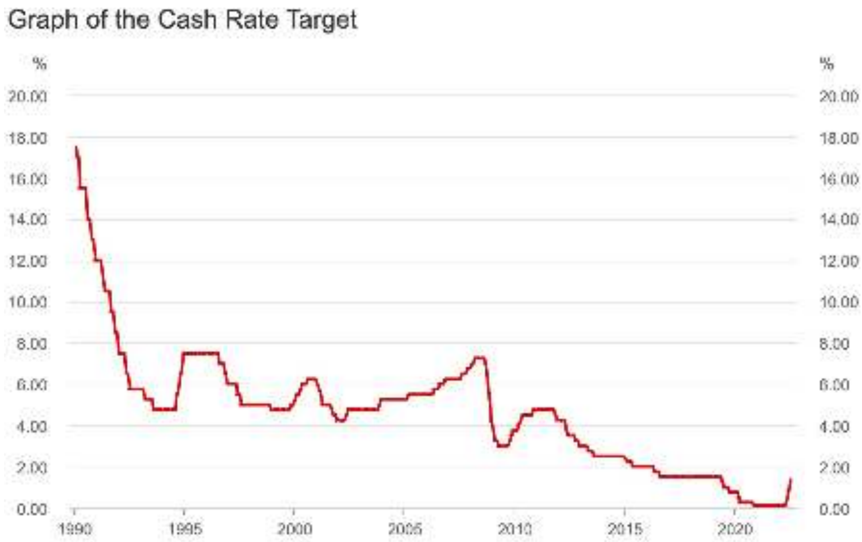
- Is the Australian Economy heading for a recession?
- A more in depth explanation of the labour market tightness, how high rates will rise and how much monetary policy will be utilised.

RBA Recap

Central Banks Forced into Rear Guard Action

Over the past two months we have seen flurry of central bank activity as the fight against inflation ramps up. First, we saw the RBA step up its efforts to 'normalise' monetary policy by lifting the cash rate by 50bp at their June meeting. The US Federal Reserve then went one step further by ratcheting up their overnight reference rate by 75bp, the biggest single move in decades. Then the RBA hiked 50bps for the second meeting in a row in July.

It has many causal observers questioning what is going on and how did we get from ultra-low and accommodative policy, with promise that it would remain that way until 2024, to central banks waging the biggest war on inflation since the Volcker years of the late 70s and early 80s.



Source: RBA

One way to look at how we arrived at the current situation we find ourselves in is to understand what Governor Lowe said when looking back at the RBA's actions in an interview last month on the 7:30 report. He was specifically asked if the Government and the RBA did too much to support the economy during the pandemic to which he responded:

"The Reserve Bank strategy at the time was twofold. First, to build a bridge to the other side. We were looking into the chasm and that was very scary. We wanted to build a bridge to the other side. And the other thing we wanted to do was provide some insurance, some economic insurance for the country, that if the really bad outcomes were going to eventuate, that we would be there and we would be able to support people."

His overall response was quite detailed but ultimately, he summed it up by saying:

"We took out insurance. Maybe we took out too much but in the time that we faced and the decisions that we had to take, I think was the right thing to do."

While that sums up what is happening on the demand side, it only tells one side of the story. On the other side of the demand/supply equation we still have supply side issues permeating across many sectors and industries around the world for a variety of reasons.

Covid related supply side issues are still very prevalent across the world, but most notably in China where they continue to pursue a zero covid policy. Covid infections and restrictions are having an ongoing effect on manufacturing which reverberates along the supply chain. It is also having a pronounced impact on labour supply which in turn is having widespread implication for inflation. Add to that the impact of supply that the unrest in Europe is having along with weather related supply side impacts, and we have a perfect storm for inflation.

Faced with both supply push and demand pull inflation, central banks are only left with one option. They have no control over the factors impacting supply so are forced to take the fight up on the demand side in order to bring balance back to supply and demand, in doing so reducing upside pressure on prices.

As a result, central banks are attempting to normalise monetary policy in their respective jurisdictions to reduce demand. This will in time take balance the supply/demand dynamics and reduce the speed of inflation. The quicker they can do this the quicker the supply side can catch up and a more evenly balanced operating environment can resume.

However, this comes with risks, something that hasn't gone un-noticed by markets. Talks of a recession globally are growing and markets are starting to price in rate cuts, yes rates cuts in the not too distant future.

There is a growing consensus that central banks are going to have to go hard in order to bring demand down far enough to help bring price pressures under control. The rational is that there is a risk that demand will fall far enough to result in a recession. Once demand has fallen far enough to allow supply side pressures to ease, central banks will then need to kick start demand again. Not with the same rigour as we have just witnessed during the pandemic, but some support might be required.

Time will tell how this unfolds. In all my time watching and commentating on markets I have never seen such a divergent range of potential outcomes and opinions on the outlook. What we know for sure is that central banks are going after inflation and will continue to tighten policy until inflation is under control. What the outlook looks life from there is a much harder set of variables to bed down.

David Flanagan – Head of Money Markets

Markets Recap

Funding Dynamic

The last month saw a frenzy of activity as ADIs sought to firm up their position before end of financial year. Further, liquidity came at a premium for ADIs, who saw high levels of loan activity coming through the pipeline. Adding greater pressure on bank funding is a decrease in amortisation rates as mortgage owners have less disposable income to put towards their mortgage.

End of month rebalancing can place serious pressure on funding requirements. This problem becomes exacerbated at the end of financial year as ADI statistics are made public. Window dressing of liquidity levels and balance sheet targets can see ADIs pricing well above the market to ensure ratios are right.

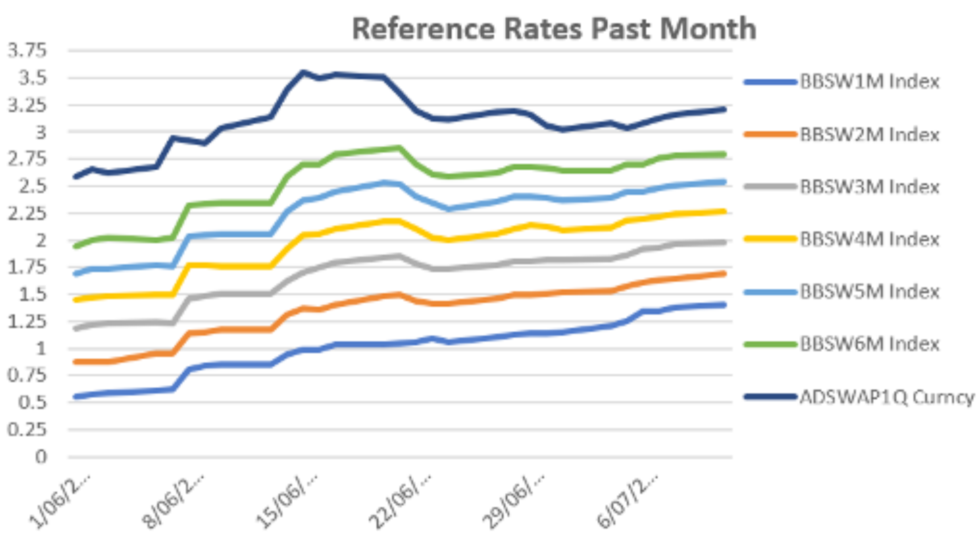
Loan levels have remained elevated during the past month. Whilst it might seem on the surface that households may be rushing in and taking advantage of low rates, more realistically the pipeline of loans written in the previous months (pre-RBA rate hikes) is flowing through. However, a rush from households cannot be ruled out and this would be a contributing factor.

With the RBA hiking rates, mortgage prepayments will slow. Quite simply, if more money is required to service mortgages, then households have less disposable income (ceteris paribus - all things kept the same). On the ADI side, whilst they receive more money interest revenue, they also receive a smaller amount of cash overall. Therefore, increasing the need for funding from wholesale markets.

The last month was the tightest on liquidity for some time. Turn back 6 months and ADIs still had plenty of funding from TFF spill over. Investors with funds to spend were compensated well as will be discussed below.

TDs and NCDs

Term Deposit and NCD rates remain elevated over the past month. Whilst the funding dynamic above was responsible for some of the increase, reference rates also continued to rise.



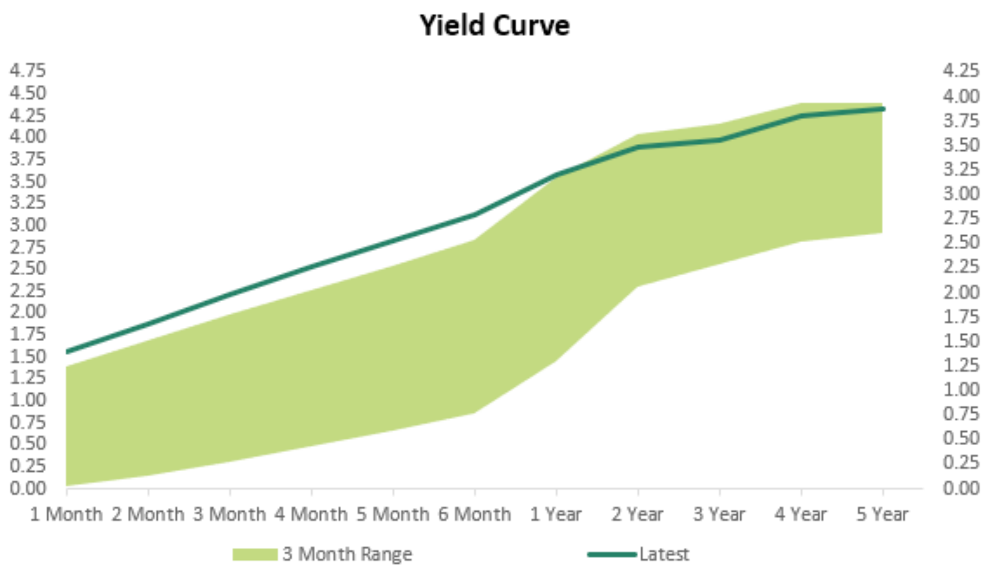
The start of June saw the RBA hike by 50 basis points. The market was expecting at 40 basis point hike, so reference rates saw an immediate pick up in response. Rates continued to creep up as the market priced in another 50 basis point hike in July. This continued to keep term deposit and NCD prices elevated, but not at the extreme levels as seen in May.

Closer to the end of the financial year, banks were paying any amount necessary to attract funding. Within the NCD space, margins got around +50 for 3 months. NCD Margins moved from +20 to +25 to +30 over the course of the month and have remained at this level. Longer dated term deposits were very attractive, touching 4% for 12 months and close to 5 for investors willing to invest for several years. Unrated ADIs saw heightened demand for funding, paying around +70 over 3M BBSW to attract funding.

If liquidity is to remain tight within the market, discretionary rates are more likely to be achieved. Banks understand that retaining funds is easier than attracting new business. Therefore, banks are willing to match the best rates on offer. Attractive rates will remain available for the foreseeable future.

The Yield Curve

The yield curve flattened over the course of the month. The front end continues to sell off in response to inflation worries and to price in further rate hikes from the RBA. The back end has rallied, as the market determines where a terminal cash rate may lie and the possibility of rate hikes in the future.



Attractive returns remain available within the securities market. Fixed rate bonds are trading with yields higher than term deposits are returning. Investors are being heavily compensated for interest rate risk and yields have sold off quickly. Bonds that were issued with large coupons are still trading at a premium. However, many bonds can be found at a discount.

Floating rate notes continue to return attractive coupons as BBSW continues to increase steadily. Further, the added bonus of mitigating the interest rate risk. Mark to market valuations on fixed income securities are poor, as the market continues to sell off. Holding these instruments to maturity will prevent any capital loss.

Investing Considerations

Diversity Within A Portfolio

The current market has provided investors with the opportunity to diversify their portfolio. During the last couple of years, many banks did not require wholesale funding, receiving their funds from TFF. As a result, investors had few names which they could invest their funds with. Most of their funds would be placed with a limited number of ADIs and portfolios were not diverse.

The current market has provided investors with ample ADIs searching for funding. This presents a great opportunity to diversify portfolios, and in many cases increased return. By increasing exposure to ADIs, investors reduce their risk. One reason being that the first $250k is covered by the government guarantee. The second reason is that each bank will have a different exposure profile and therefore mitigates risk.

Now is a better chance than ever to increase diversity of a portfolio.

Nicholas Allan – Senior Associate, Money Markets

The Australian Economy

Where Are We Headed

The performance of the economy as evidenced by the incoming data over the coming months will be critical to how far the current tightening cycle has to run and how fast we get to the terminal rate. The RBA characterises the economy at present as resilient and so far the data released to date supports that view. Trade data shows strength in both exports and imports while retail sales remain strong as the economy continues to emerge from the pandemic headwinds.

Monthly Data

	Period	Value/Index	MoM	YoY
TD-MI Inflation	June	125.11	0.3	4.7
TD-MI Trimmed Mean	June		0.3	3.0
Unemployment Rate (%)	May	3.9	0.0	-1.2
Total Employment ('000)	May	13,511	60.6	386.0
Full Time Employment ('000)	May	9,443	69.4	474.2
Part Time Employment ('000)	May	4,068	-8.7	-88.0
ANZ Job Advertisements	June	243,523	1.4	18.4
NAB Business Confidence	June	1.4	-4.9	-18.5
NAB Business Conditions	June	13.0	-2.3	-15.1
NAB Employment Index	June	9.8	-2.2	-10.3
Consumer Confidence	June	83.79	-2.6	-23.4
Retail Sales	May	$34,229	0.9	10.4
Trade Balance ($m)	May	$15,965	$2,717	$5,980
Exports ($m)	May	$58,402	9.5	38.1
Imports ($m)	May	$42,437	5.8	31.4
Housing Finance Ex-Refi ($m)	May	$32,368	1.7	-0.4
Housing Finance O/O Ex -Refi ($m)	May	$21,185	2.1	-9.7
Housing Finance Inv Ex-Refi ($m)	May	$11,183	0.9	23.7
Building Approvals Total	May	$16,390	9.9	-20.9

With incoming data holding the key to the outlook for monetary policy, what is it that we should be paying close attention too in the months ahead? The RBA highlighted at their June meeting that despite most of the inflationary pressure being attributed to global forces, there were some domestic factors at play. More specifically *“Strong demand, a tight labour market and capacity constraints in some sectors are contributing to the upward pressure on prices.”*

Given that the bulk of inflationary pressures are global in nature, the CPI numbers in the next couple of quarters are likely to carry a little less weight than usual on monetary policy decisions. The RBA is going to be more focused on how demand indicators are evolving as interest rates rise for signs that tighter policy is having an impact.

That means that consumer data points will be closely watched. We know that consumer confidence is already under pressure. However, we are yet to see a meaningful impact on consumption metrics. There are some signs that housing market related metrics are under pressure but there were signs that the housing market was losing momentum before rates started to rise.

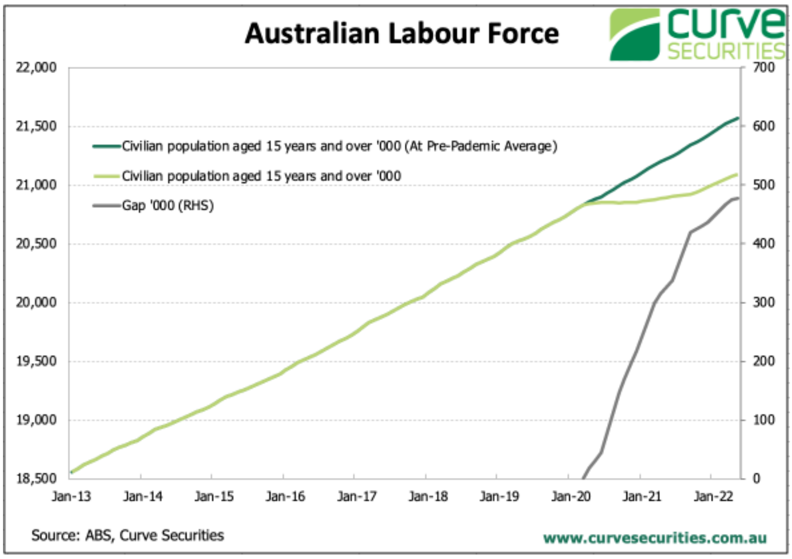
Quarterly Data

	Period	Value/Index	QoQ	YoY
GDP ($m)	Q1	$527,676	0.8	3.3
CPI	Q1	123.9	2.1	5.1
CPI - Trimmed Mean	Q1	122.8	1.4	3.7
House Prices	Q1	196.1	5.3	27.5

Beyond the consumption data, which will be important in the short run, it is the developments in the employment market that will ultimately have longer term implications for the outlook for monetary policy. The headline employment numbers show a picture of strength as the economy has emerged from the pandemic and associated restrictions. The unemployment is rate is at a multi-decade low and the participation rate at a record high. On the back of this, wage growth is expected to pick up over the coming quarters.

But there is more to the story once you look beyond the headline numbers. One of the reasons that the unemployment and participation rate are where they are, has to do with the broader labour force and population dynamics.

The movement of labour during the pandemic has been mentioned at times by the RBA. Close to half a million temporary visa holders headed back to their respective countries during the pandemic. Add to that the lack of new immigration and limited repatriation of Australian expats working overseas and we have seen a significant impact on the size of the labour force. The size of the population 15 and over is roughly lower by over 470,000 people that might of otherwise been the case had the pandemic not hit.



With that many less workers available to fill rolls you can see why the unemployment and participation rates are where they are. It also explains why many industries are finding it difficult to find workers. There is the assumption that if you simply lift wages you will find workers but many businesses aren't in a position to sustain higher wages. Even if they are, there isn't necessarily enough workers to go around depending on the skill set required.

How this balances itself out over the coming months will be the key to the longer term outlook for wage pressures, inflation and monetary policy more generally.

So, in the near run, keep an eye on demand dynamics for clues on how far and fast rates will rise. However, in the long run the employment data is will have a greater bearing on monetary policy.

David Flanagan – Head of Money Markets

This document is intended to provide you with general information only. It does not take into account your investment objectives, financial situation or particular needs. Before acting on this information, you need to consider the appropriateness of the information in lieu of your

investment objectives, financial situation or needs.