Weekly Update

5 February 2024

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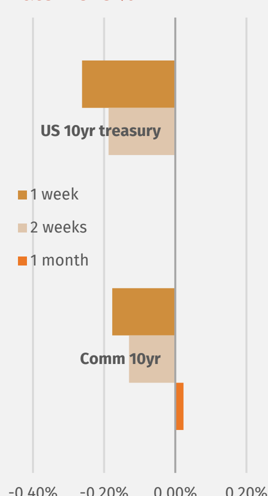
Interest Rates

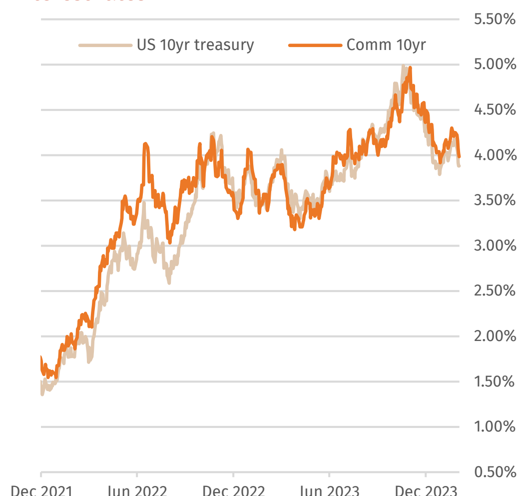
- The market took some comfort from the dovish tone to the FOMC minutes last week, although Powell dashed any hopes of a March rate cut. The US yield curve appeared to be comfortable to continue to trade around recent levels until the market was shocked by Friday night's Non-Farm Payrolls that were twice market expectations with upward revisions to the December data too. This pushed the US 10 year back over 4% where many traders would have been stopped out. In the first Fed meeting of 2024 in early February the Fed kept cash rates steady for the fourth meeting in a row.
- Australian bond yields tracked the US bond yields over the week. After weaker than expected December quarterly CPI data the spread between the US and Australian 10 year contracted into 1-2bps before pushing back out to near 10bps by the end of the weak. Markets don't expect the RBA to change rates at this week's meeting but a still hopeful of cuts later in the year.

Rate move %



Source: Eikon

Interest rates

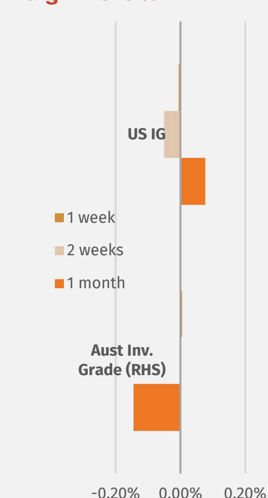


Source: Refinitiv

Major Credit Markets

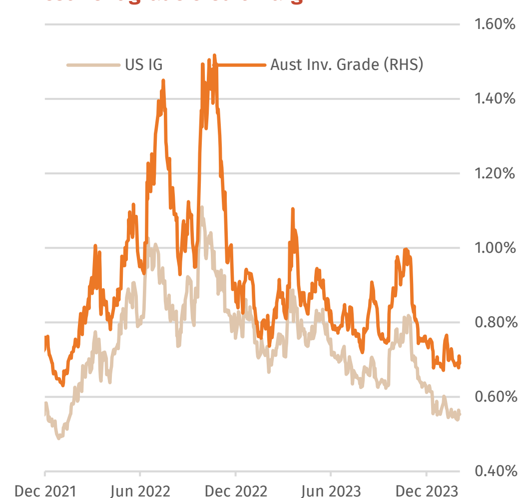
- US credit spreads contracted in January buoyed by the strong economic data and the new records set by the equity market. The "Goldilocks" style soft landing is now fully priced in credit spreads. Investment grade (IG) markets have remained firm with a strong start to the year for issuance as well as fund flows into all varieties of IG funds.
- Australian spreads traded near the lows seen over January with the market able to absorb 2 of the major banks issuing domestic senior paper and ANZ issuing a huge $2bn Tier 2 10NC5 note at +195bps. NAB followed this with $1.75bn of 10NC5 Tier 2 notes comprising $1.1bn floating rate at 1.95% above BBSW and $650m fixed rate note also at a 1.95% margin giving a 5.74% coupon. NAB also issued a covered bond into Europe at a margin of 0.58%. Other notable issuers last week were Heritage Bank (rated BBB) with a senior unsecured 3-year floating rate note at BBSW + 1.60% and VW Australia (rated BBB+) $500m of a 3-year unsecured senior note at 5.38%, a swap margin of 1.60%.

Margin move %



Source: Eikon

Investment grade credit margin

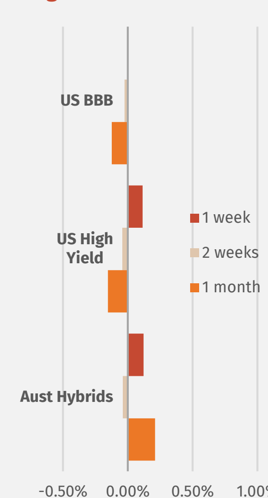


Source: Refinitiv

High Yield Markets

- Despite large fund inflows into the US high yield (HY) sector, average HY spreads have widened by 22pts over January on large volume. This may have been impacted by huge issuance, January being the fourth largest on record. HY markets have been supported by the huge equity market rally, which may have prompted the issuance.
- Hybrids have bided their time in recent weeks. The usual January rally was not as strong as usual with the market expecting large issuance in the first half of 2024 as banks move to beat any APRA changes. The average major bank margin finished last week at 2.47%, a high since the recent low which was 2.30% on 29 December, the last trading day of 2023. The Evans and Partners hybrid index returned 0.37% in January.
- ANZ announced that a rollover issue for the $1.6bn AN3PG will occur in late February. CBA also has a large issue with a redemption call in April.

Margin move %



Source: Eikon, Arculus

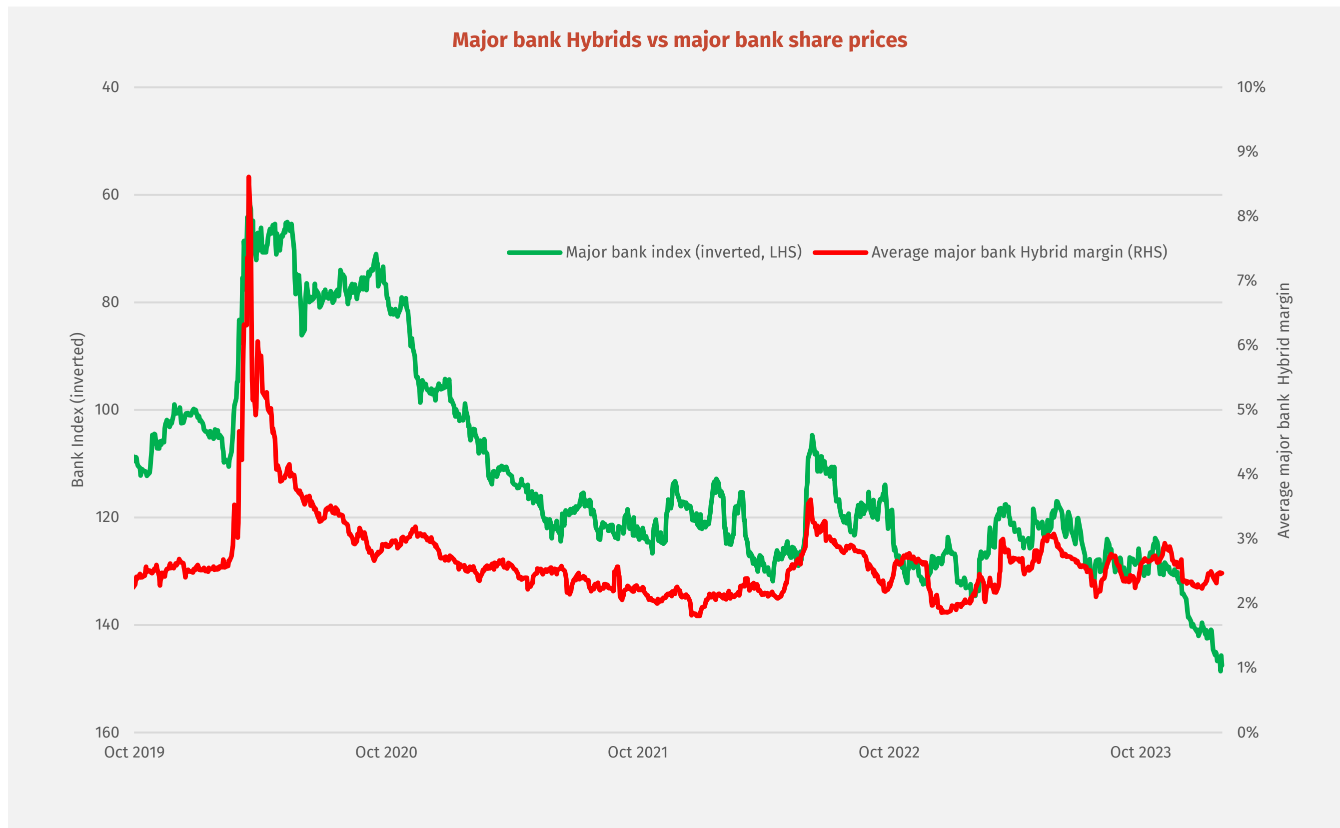
High yield credit margin

Source: Refinitiv, Arculus

Listed Hybrid Market

Hybrids – cheap relative to bank equity, fair to credit and equity volatility

- Major bank share prices have been extremely strong through January with the market leader CBA reaching a new all-time high, adding 3.67% YTD after adding 11.83% in the December quarter. The chart below shows an index of the major banks' total returns (see the green line and note that it is inverted to show the relationship with hybrid margins) and the average hybrid margin (red line). The fall in the green line in recent months illustrates the recent strong bank share price performance. Hybrids don't necessarily have to follow bank equity; however, this is a glaring disparity. Other metrics to measure hybrid value are equity market volatility and credit spreads of better ranked bank debt. Against these other yardsticks, hybrids are fair to slightly cheap.



Source: Refinitiv, Arculus

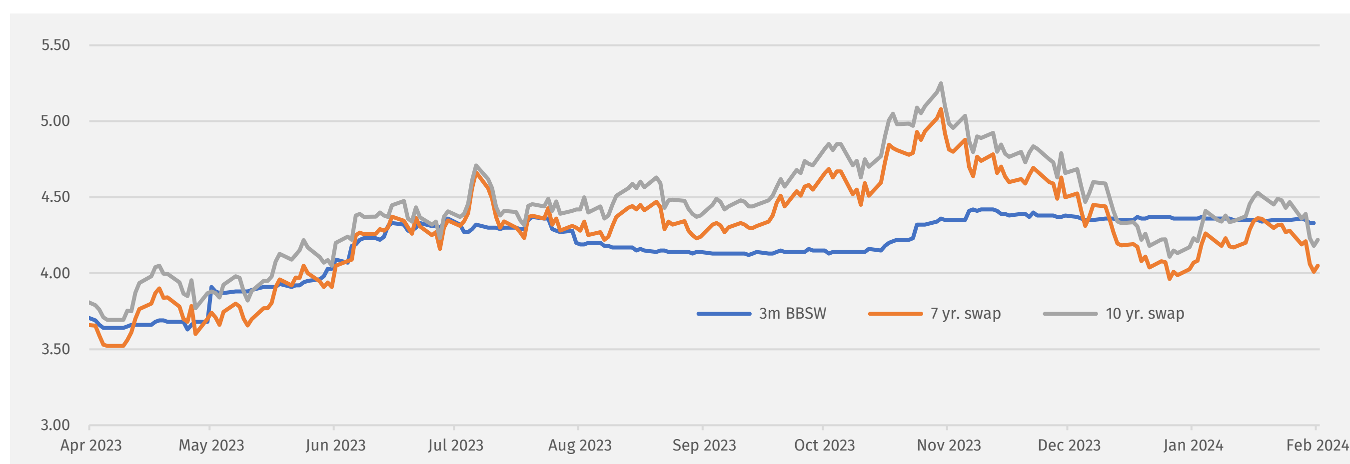
- The strong bank share price performance has lowered the yield on bank stocks. As a result, for the first time since the GFC, the yields on major banks stocks are the same as that on hybrids. The chart below shows the yield history for bank stocks and hybrids. This will not last. Investors will up weight hybrids and down weight ordinary bank equity. The conclusion is that bank share prices provide a buffer for hybrids, which are well off margin lows. Bank share prices could retrace the recent strong performance without impacting hybrids. In fact, investors will start switching from bank stocks to hybrids soon to maintain yield exposure and capture the bank share price performance.

Source: Datastream, Evans and Partners

Forward Interest Indicators

Australian rates

- Swap rates fall along with the general fall in bond yields after softer than anticipated inflation data.
- Swap rates:
  - 10-year swap 4.22%
  - 7-year swap 4.05%
  - 5-year swap 3.93%
  - 1-month BBSW 4.30%

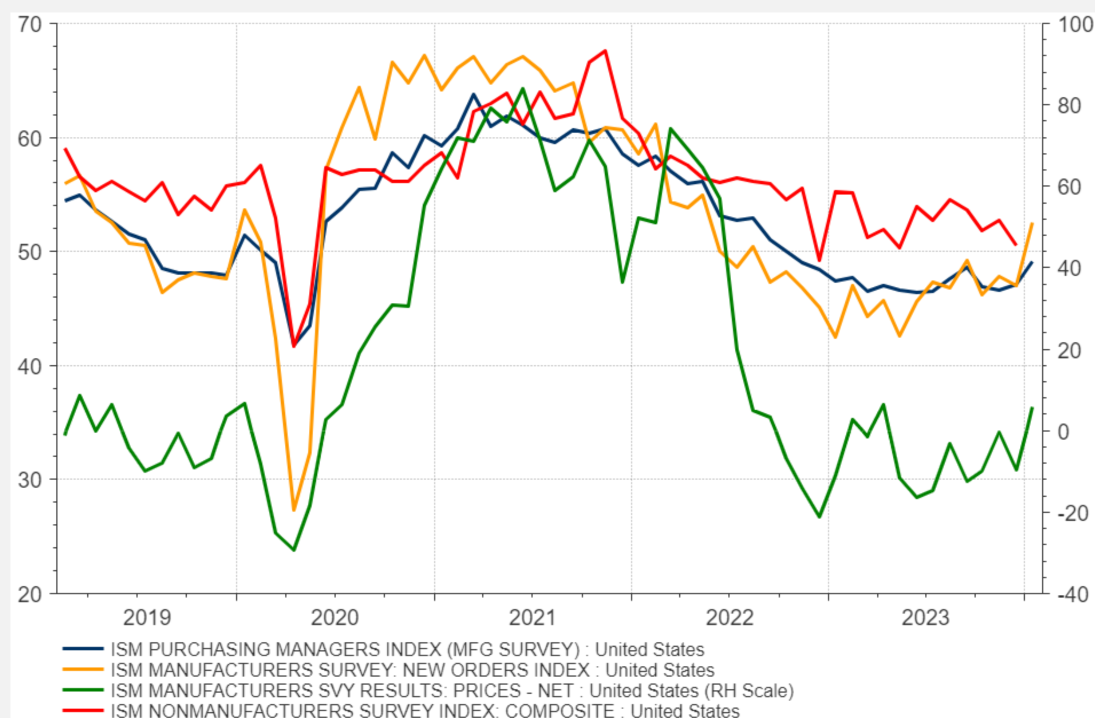


Source: Refinitiv

Week Ahead

- The week ahead will be a quiet one for data with the exception of the ISM PMI Services index release. If this forward indicator of services activity shows strength it will support the possibility of the wages growth pivoting to being increasing again. In December the ISM Services PMI unexpectedly fell to 50.6 from 52.7 in November with a slowdown in new orders, employment and a contraction of inventories. It was, however, evident from the increased production of services and the easing of price pressures that this was due to an increase in labour productivity. This would need to continue in the months ahead if the US is to achieve a soft landing.
- If the Services PMI (red line) increases in January then it will join the recent strength seen in manufacturing with the PMI Manufacturing index, prices and new orders rising last month.

US ISM PMI data - manufacturing outlook



Source: LSEG Datastream

Calendar

Monday, 5 February

- EU PPI data

Tuesday, 6 February

- US ISM PMI services index
- Canada Market Participants Survey
- Japan household spending
- Japan average cash earnings
- Australia retail sales
- Australia RBA meeting decision
- EU Retail sales
- Italy business/consumer confidence
- US total household debt
- US Redbook

Wednesday, 7 February

- RBA chart pack
- Japan leading index
- France payrolls
- France trade data
- Italy retail sales
- US trade data

Thursday, 8 February

- US building permits
- US private house approvals
- China inflation data
- Japan foreign bond investments

Thursday, 8 February (continued)

- US used car prices
- US initial jobless claims
- US continuing jobless claims

Friday, 9 February

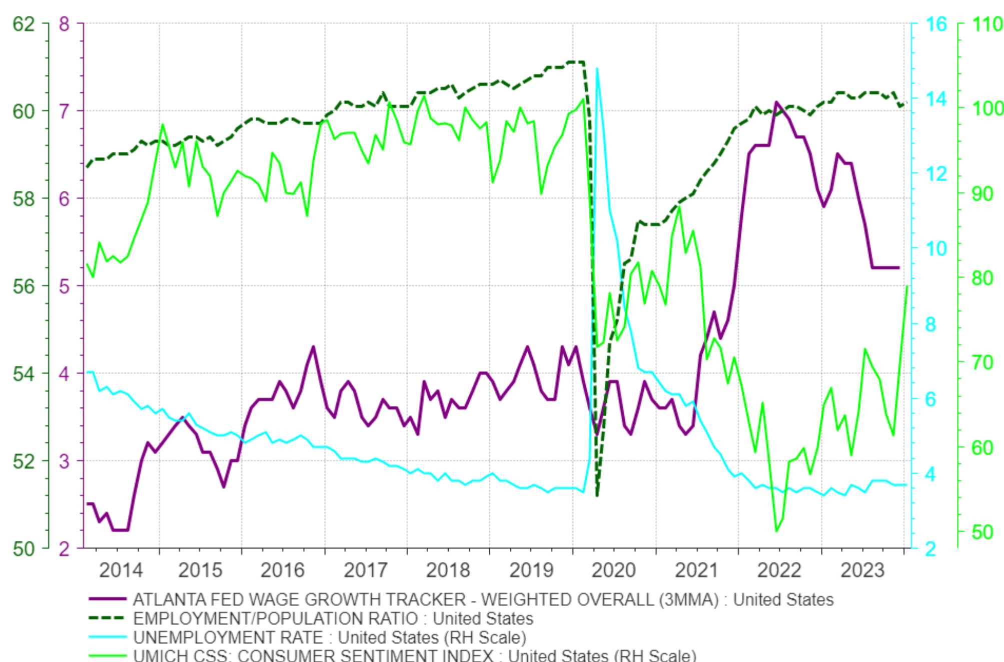
- RBA Bullock speech
- Germany inflation

Macro View

- The Federal Reserve last week, again, left rates on hold at its January meeting with Powell ruling out a March cut but otherwise keeping his dovish tone. The Federal Reserve has been able to move to a hold status for 3 reasons:
    1. The rise in the USD while other currencies fell will see a shift from US exports to imports with a lag of indeterminate length.
    2. The transitory factors from the pandemic abating have pushed down durable goods prices and with it headline inflation.
    3. They have achieved negative broad money growth so from a monetarist perspective can afford to be patient.
- The market has rushed to assuming that the Federal Reserve will cut rates once magically the inflation rate returns to its target. This is simply a false narrative based on the greed of Wall St's need to find a reason to keep equities rising. At the November meeting – not that long ago – the Federal Reserve made the following statement:

    "Recent indicators suggest that economic activity expanded at a strong pace in the third quarter. Job gains have moderated since earlier in the year but remain strong, and the unemployment rate has remained low. Inflation remains elevated. The U.S. banking system is sound and resilient. Tighter financial and credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain. The Committee remains highly attentive to inflation risks." (FOMC)
- If anything, the recent resurgence in employment – confirmed again last Friday night with a January payrolls number well above 350,000 when only 175,000 was expected – and the increase in mortgage applications, new home application and job openings all confirm that the November statement from the FOMC has been quite accurate. Now, like a ghost rising to again haunt the markets, we are seeing consumer sentiment rising. Taken together, the very, very low level of unemployment that finds everyone wanting a job, with a job, is a supporting household consumption, GDP growth and with the usual lag, ongoing employment strength. Watch for increases in the Atlanta Wages growth index next month.

Wages growth and employment - consumer sentiment and inflation



Source: LSEG Datastream

- We have to remember that while the Fed may not increase rates again this cycle it will be still reducing QE gradually. The next big reduction in QE will be the cessation of the Bank Term funding program (about $141bn) put in place last March after the mini bank crises. Investors need to stop focusing on Fed policy and official rate outcomes and instead focus on the yield curve. The Fed may keep the short end of the yield curve anchored for a very long time but there will be a lot of volatility along the curve because there are fundamental demand and supply factors at work in the bond market irrespective of the inflation outcome.
- On the demand side we have lost 3 of the major buyers of US bonds:
  1. China is no longer investing as much in US bonds and instead is making its own currency the means of exchange with trading partners.
  2. Japan is no longer a buyer of US bonds due to the Yen's weakness.
  3. The US Federal Reserve is no longer a buyer due to the unwinding of the flawed modern monetary theory that led to the excess QE.
- On the supply side:
  1. The US Treasury with its bond auction plans announced last week confirmed that bond issuance will rise over the next 4 months considerably. In early November when the US 10-year bond was on the verge of breaking the key 5% level and making all asset markets unstable the US Treasury stopped selling bonds (as it had been a heavy seller in August and September) and switched to financing the government outlays by selling US Treasury Bills (less than 12 months to maturity).
  2. The switch by the US Treasury then encouraged banks that had been parking their reserves at the Federal Reserve to switch out into bonds. This brought about something of a short covering rally in US bonds accentuated by the large scale of the "US Basis Trade" (hedge funds buying US Treasuries and shorting futures while the Banks were long futures and short Treasuries). In the last part of January, we saw signs that funds are again switching back into the Federal Reserve with the New York Federal Reserve taking some large Reverse Repo Bids.
  3. The US Budget Deficit does not look like shrinking anytime soon and the current Congress appears resigned to adjusting the debt cap on an ongoing basis to accommodate it. This is an election year so it hardly seems likely that either party will actually be campaigning on cutting government spending. In fact, it is quite likely that the rise in geopolitical tensions (Ukraine, Iran, Yemen, Syria, Iraq and Judea) will see the US have to lift its spending on defence.

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