FIIG | The fixed income experts

Credit Research
Credit Strategy

The decade of March 2023

27 March 2023

“*There are decades when nothing happens; and there are weeks when decades happen.*” Vladimir (Ilyich Ulyanov) Lenin

Company
Various

Garreth Innes

Deputy Head of Research
+61 8 9421 8507
garreth.innes@fiig.com.au

- In what has felt like a decade, we thought it would be instructive to take stock and see the lay of the land post the incredible bank failures in the US and the hastily arranged marriage between UBS and Credit Suisse. Suffice to say, it is unlikely that former Credit Suisse AT1 noteholders will be sending anniversary cards in coming years.
- We have covered the specifics of each of these idiosyncratic events in prior notes (One week later – Now What? and Lessons from the Credit Suisse events), whereas this note will focus on the here and now across asset classes – the period in which the dust has settled. Or has it?
- In this note, we discuss the reaction of various segments of the markets to what has transpired, and outline why we feel that now is a time to be alert, but not panicked. We continue to advocate an up-in-quality bias and are increasingly interested in longer-dated, fixed rate non-financial investment grade corporate bonds for their potential to add value to a diversified investment portfolio if things were to worsen.

Temperature Check

- To get a feel for the current settings in financial markets, we first review a few traditional stress markers. There are a couple of go-to indicators for stress within financial markets. The first is called the ***FRA/OIS spread*** – effectively the difference between short-term unsecured lending rates between banks and the short-term risk-free rate (i.e. a reflection of how markets price the banking sector risk). When this spreads gaps out, short-term funding becomes more expensive for banks and this tends to get passed on to broader funding markets (including the credit market).

Figure 1: USD FRA-OIS (3 month) spread

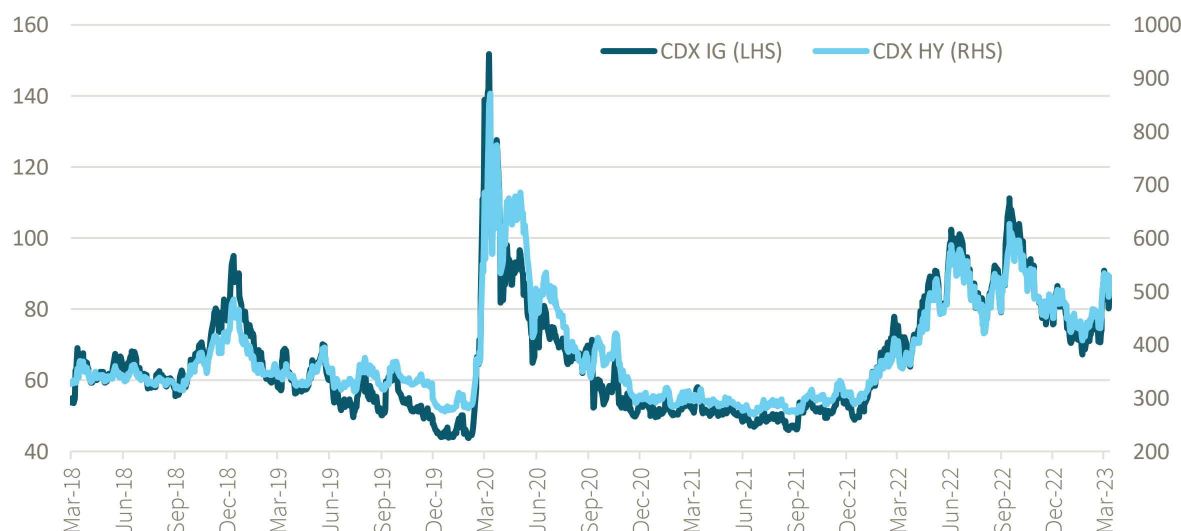
Source: FIIG Securities, Bloomberg

The contents of this document are copyright. Other than under the Copyright Act 1968 (Cth), no part of it may be reproduced, distributed or provided to a third party without FIIG’s prior written permission other than to the recipient’s accountants, tax advisors and lawyers for the purpose of the recipient obtaining advice prior to making any investment decision. FIIG asserts all of its intellectual property rights in relation to this document and reserves its rights to prosecute for breaches of those rights.

The decade of March 2023

- While the spread has definitely widened, it did not exceed the peak of the initial COVID scare in 2020, and has tightened around 20bps since the initial spike to sit around 40bps currently – relative to the headlines, this seems a remarkably good result and most likely speaks to the timely containment measures announced by policymakers on both sides of the Atlantic.
- A similar picture emerges for ***liquid US credit default swap indices***, indicating some element of concern, but no panic, with spreads on both the Investment Grade and High Yield indices well below levels reached in 2022:

Figure 2: US Credit Default Swap Spreads



Source: FIIG Securities, Bloomberg

- The centre of attention in the last week was understandably ***the Additional Tier-1*** space in financials. While we saw some knee-jerk reactions to the initial headlines (and no real differentiation between banks, countries or instrument types), the actual traded prices of Australian and other non-Swiss AT1 paper has recovered by at least 40% to 50% from the intra-week lows, and we were glad to see clients take advantage of some great opportunities in this space. Australian investment grade credit spreads were much better behaved, with spreads only widening 25bps since the beginning of March.
- When there are heightened concerns in the market, the ***cost of borrowing US dollars*** (and the USD itself) usually jumps. However, given the initial source of the current angst emanated from some poorly managed US banks, the broad US dollar index has weakened more than 2% since the beginning of March. This could also be due to the extension of US dollar swap funding lines by major global central banks and the announcement of the Bank Term Funding Program, which has increased the size of the Fed's balance sheet once again (both factors leading to increased liquidity provision in the global financial system and taking pressure of US dollar funding).
- One part of the market that has reacted more sharply is the ***government bond market***. US bond yields have aggressively priced out future Fed hikes, with implied pricing of the Fed Funds rate as at December 2023 falling from 5.5% to less than 4% (remembering after this week's hike from the Fed, the current upper bound is 5.0%):

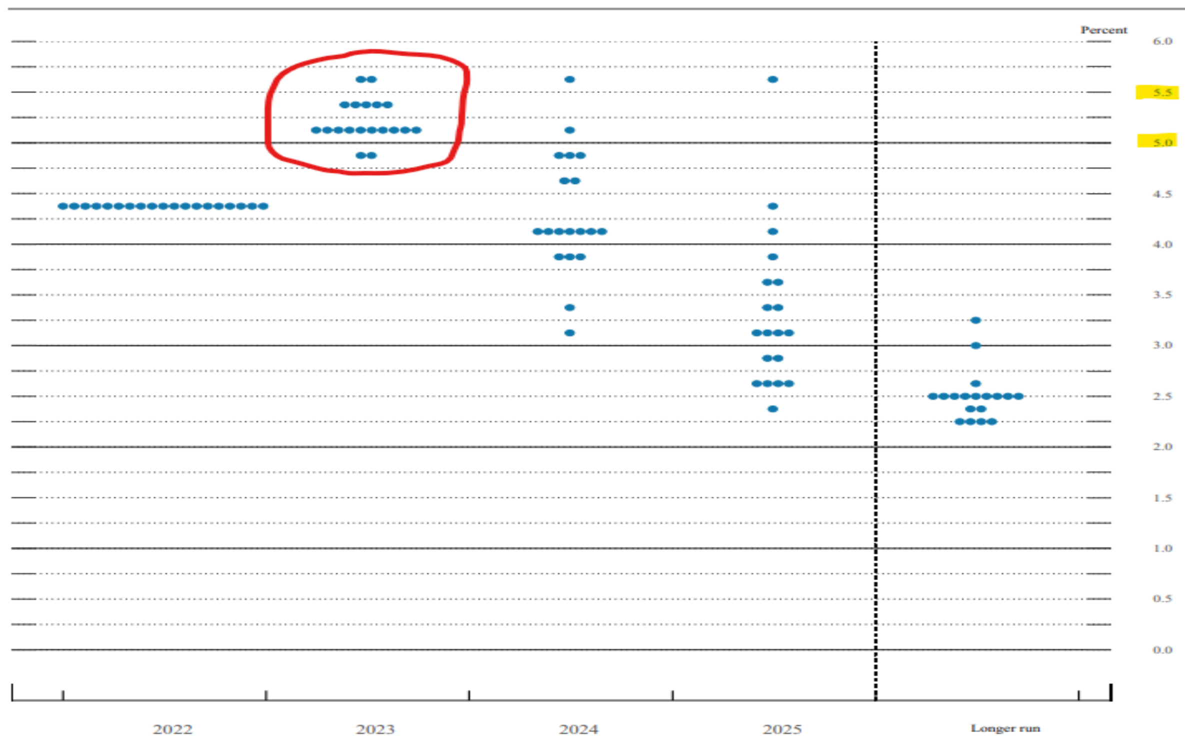
The contents of this document are copyright. Other than under the Copyright Act 1968 (Cth), no part of it may be reproduced, distributed or provided to a third party without FIIG's prior written permission other than to the recipient's accountants, tax advisors and lawyers for the purpose of the recipient obtaining advice prior to making any investment decision. FIIG asserts all of its intellectual property rights in relation to this document and reserves its rights to prosecute for breaches of those rights.

The decade of March 2023

Figure 3: Implied Fed Funds Rate for December 2023 meeting

Source: FIIG Securities, Bloomberg

- That is not an insignificant retracement in a matter of weeks, and speaks to the market's view that the Fed is a lot closer to peak rates than they are currently letting on in official communications – see the Dot Plots below for the Fed's view of where rates will be in December 2023 (although interestingly most Fed members see a number of cuts by the end of 2024):



Source: Federal Reserve Monetary Policy Report, March 2023

The contents of this document are copyright. Other than under the Copyright Act 1968 (Cth), no part of it may be reproduced, distributed or provided to a third party without FIIG's prior written permission other than to the recipient's accountants, tax advisors and lawyers for the purpose of the recipient obtaining advice prior to making any investment decision. FIIG asserts all of its intellectual property rights in relation to this document and reserves its rights to prosecute for breaches of those rights.

The decade of March 2023

- *Gold* (and Bitcoin, for that matter) caught a bid, briefly surpassing USD2000/oz and climbing by around 9% since the beginning of March, while *WTI* oil contracts have fallen by 3% month to date. Hardly panic stations, then.
- Last, but not least, are the *equity markets*. The S&P 500, whilst down around 6% from its recent peak in early February, is broadly flat during March. Simply looking at the index, you wouldn't know anything had been going on! The banking sectors in Europe and the US have understandably fared much worse, down 15 to 20% respectively, while the Australian bank index is down just 7%, outperforming handsomely.

Where does this leave us?

- In the case of the Fed vs. the bond market, history sides with the bond market and we see the potential for a further tightening in broader credit provision on account of higher base rates and consistently downward-pointing growth indicators. We also think the Fed is much more acutely aware of the problem that significantly higher money market rates (compared to deposit rates) can create, and despite what they (and the ECB) communicated at the March meeting, will be reticent to add to financial stability concerns in the form of further aggressive hiking from this point forward.
- The sharp rally in base rates, which leads to tighter financial conditions for most consumers and corporates, is yet to be fully felt, as many were able to term out their debt maturities in recent years. The full brunt of higher refinancing costs is *in front* of us, and we cannot say with certainty that Silicon Valley Bank, Signature Bank of New York and Credit Suisse are going to be the last casualties of this significant regime change.
- Case in point – as I type this, First Republic Bank remains in the headlines for all the wrong reasons, while Treasury Secretary Janet Yellen has been talking about the potential for a broadening of the depositor bail-out that was applied in the cases of Silicon Valley Bank and Signature Bank of New York.
- One of the ironies of the current dynamic is that deposits are flowing into major banks at a rapid clip, leaving them in an even stronger liquidity position than before this mini-crisis. We are nearly at the point of needing to create a new acronym for major US banks such as JP Morgan and Bank of America – WTBTF ('Waaaaaaay too big to fail').
- Generally, we retain an up-in-quality bias, selectively recycling into higher-rated bonds and for the first time in a while, are advocating for an increase in longer-dated, fixed rate investment grade corporate bonds as part of a diversified bond portfolio. If risk-off persists, for whatever reason, duration still offers the capacity to protect capital as yields remain elevated relative to the last 10 years.
- Alert, but not panicked, feels about right at this point.

The contents of this document are copyright. Other than under the Copyright Act 1968 (Cth), no part of it may be reproduced, distributed or provided to a third party without FIIG's prior written permission other than to the recipient's accountants, tax advisors and lawyers for the purpose of the recipient obtaining advice prior to making any investment decision. FIIG asserts all of its intellectual property rights in relation to this document and reserves its rights to prosecute for breaches of those rights.

The decade of March 2023

The contents of this document are copyright. Other than under the Copyright Act 1968 (Cth), no part of it may be reproduced, distributed or to a third party without FIIG's prior written permission other than to the recipient's accountants, tax advisors and lawyers for the purpose of the recipient obtaining advice prior to making any investment decision. FIIG asserts all of its intellectual property rights in relation to this document and reserves its rights to prosecute for breaches of those rights.

The information has been prepared solely for informational purposes only and does not constitute or form part of any offer for sale or subscription of, or solicitations or any offer to buy or subscribe for, or any invitation to subscribe for or purchase any securities and nothing contained herein shall form the basis of any contract or commitment whatsoever. The information is being furnished to you solely for your information and may not be reproduced or redistributed to any other person. No action has been taken to permit the public distribution of the information in any jurisdiction and the information should not be distributed to any person or entity in any jurisdiction where such distribution would be contrary to applicable law.

The information has not been lodged with Australian Securities and Investments Commission or any other authority. The information is intended for distribution only to financial institutions and professional investors whose ordinary business includes the buying or selling of securities in circumstances where disclosure is not required under Chapter 6D.2 or Chapter 7 of the Corporations Act 2001 of Australia (the "Corporations Act") and only in such other circumstances as may be permitted by applicable law. Any securities that may be offered by the Issuer in, or into, Australia are offered only as an offer that would not require disclosure to investors under Part 6D.2 or 7.9 of the Corporations Act. This information is directed only to persons to whom disclosure is not required under Part 6D.2 or 7.9 of the Corporations Act. The information is a summary only and does not purport to be complete. It does not amount to an express or implied recommendation or a statement of opinion (or a report or either of those things) with respect to any investment in the Issuer nor does it constitute a financial product or financial advice. The information does not take into account the investment objectives, financial situation or needs of any particular investor. FIIG does not provide accounting, tax or legal advice. Prospective investors are required to make their own independent investigation and appraisal of the business and financial condition of the Issuer and the nature of any securities that may be issued by the Issuer. By accepting receipt of the information the recipient will be deemed to represent that they possess, either individually or through their advisers, sufficient investment expertise to understand the risks involved in any purchase or sale of any financial securities discussed herein.

Certain statements contained in the information may be statements of future expectations and other forward-looking statements. These statements involve subjective judgement and analysis and may be based on third party sources and are subject to significant known and unknown uncertainties, risks and contingencies outside the control of the Issuer which may cause actual results to vary materially from those expressed or implied by these forward looking statements. Forward-looking statements contained in the information regarding past trends or activities should not be taken as a representation that such trends or activities will continue in the future. You should not place undue reliance on forward-looking statements, which speak only as of the date of this report. Opinions expressed are present opinions only and are subject to change without further notice. No representation or warranty is given as to the accuracy or completeness of the information contained herein. There is no obligation to update, modify or amend the information or to otherwise notify the recipient if information, opinion, projection, forward-looking statement, forecast or estimate set forth herein, changes or subsequently becomes inaccurate.

Any offering of any security or other financial instrument that may be related to the subject matter of this communication will be made pursuant to separate and distinct documentation ("Offering Documents") and in such case the information will be superseded in its entirety by any such Offering Documents in its final form. In addition, because the information is a summary only, it may not contain all material terms and the information in and of itself should not form the basis for any investment decision. Any decision to purchase securities in the context of a proposed offering of securities, if any, should be made solely on the basis of information contained in the Offering Documents published in relation to such an offering.

Neither FIIG nor the Issuer shall have any liability, contingent or otherwise, to any user of the information or to third parties, or any responsibility whatsoever, for the correctness, quality, accuracy, timeliness, pricing, reliability, performance or completeness of the information. In no event will FIIG or the Issuer be liable for any special, indirect, incidental or consequential damages which may be incurred or experienced on account of the user using information even if it has been advised of the possibility of such damages.

FIIG has been engaged by the Issuer to arrange the issue and sale of the Notes by the company and will receive fees from the issuer of the Notes. FIIG, its directors and employees and related parties may have an interest in the company and any securities issued by the company and earn fees or revenue in relation to dealing in those securities.

FIIG provides general financial product advice only. As a result, this document, and any information or advice, has been provided by FIIG without taking account of your objectives, financial situation and needs. Because of this, you should, before acting on any advice from FIIG, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs. If this document, or any advice, relates to the acquisition, or possible acquisition, of a particular financial product, you should obtain a product disclosure statement relating to the product and consider the statement before making any decision about whether to acquire the product. Neither FIIG, nor any of its directors, authorised representatives, employees, or agents, makes any representation or warranty as to the reliability, accuracy, or completeness, of this document or any advice. Nor do they accept any liability or responsibility arising in any way (including negligence) for errors in, or omissions from, this document or advice. Any reference to credit ratings of companies, entities or financial products must only be relied upon by a 'wholesale client' as that term is defined in section 761G of the Corporations Act 2001 (Cth). FIIG strongly recommends that you seek independent accounting, financial, taxation, and legal advice, tailored to your specific objectives, financial situation or needs, prior to making any investment decision. FIIG does not provide tax advice and is not a registered tax agent or tax (financial) advisor, nor are any of FIIG's staff or authorised representatives. FIIG does not make a market in the securities or products that may be referred to in this document. A copy of FIIG's current Financial Services Guide is available at www.fiig.com.au/fsg.

An investment in notes or corporate bonds should not be compared to a bank deposit. Notes and corporate bonds have a greater risk of loss of some or all of an investor's capital when compared to bank deposits. Past performance of any product described on any communication from FIIG is not a reliable indication of future performance. Forecasts contained in this document are predictive in character and based on assumptions such as a 2.5% p.a. assumed rate of inflation (unless otherwise specified), foreign exchange rates or forward interest rate curves generally available at the time and no reliance should be placed on the accuracy of any forecast information. The actual results may differ substantially from the forecasts and are subject to change without further notice. The information in this document is strictly confidential. If you are not the intended recipient of the information contained in this document, you may not disclose or use the information in any way. No liability is accepted for any unauthorised use of the information contained in this document. FIIG is the owner of the copyright material in this document unless otherwise specified.

The FIIG research analyst certifies that all of the views expressed in this document accurately reflects their views about the companies and financial products referred to in this document and that their remuneration is not directly or indirectly related to the views of the research analyst. This document is not available for distribution outside Australia and New Zealand and may not be passed on to any third party without the prior written consent of FIIG

The contents of this document are copyright. Other than under the Copyright Act 1968 (Cth), no part of it may be reproduced, distributed or provided to a third party without FIIG's prior written permission other than to the recipient's accountants, tax advisors and lawyers for the purpose of the recipient obtaining advice prior to making any investment decision. FIIG asserts all of its intellectual property rights in relation to this document and reserves its rights to prosecute for breaches of those rights.