Australian Interest Rate Markets

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March 2016 Quarter Review

Markets finished the quarter settled after beginning in a jittery and volatile fashion. A range of destabilising factors arose in January causing all markets to fall including prices of credit market securities. One factor was the first cash rate rise in the US in eight years. The US Federal Reserve has indicated financial market volatility is important in determining their actions and will adopt a cautious approach to further increases. Other developed economies are still struggling and require consistent central bank support. Australian interest rates remain low with the RBA maintaining an easing bias. Combined with persistent low inflation, interest rates remain close to all-time lows.

The first quarter of 2016 opened with a jump in volatility in all markets, driven by large falls in commodity prices, concerns over a slowing Chinese economy and fallout from the first cash rate rise in the US for over 8 years. The US Federal Reserve also indicated a series of cash rate rises to come over 2016. This contributed to the market volatility given its potential negative effect on the economy and its likelihood to push the USD higher. The volatility led to falling long term bond rates with 10 year rates in the US and Australia close to all-time lows. Credit spreads also jumped globally resulting in falling prices for corporate bonds, despite little balance sheet stress outside the commodity sector. In the latter half of the quarter, several factors led to market stability: the ECB enacting new forms of quantitative easing, good US economic data and the stabilisation of commodity prices. More recently, US Fed commentary has indicated that the Fed has pared back their forecasts of further cash rate rises, expecting now only 1-2 rises in the second half of 2016 rather than four over the whole year. The overall message is that the pace of US cash rate normalisation will be slow. Additionally the US Fed is quite cognisant of the recent heightened market volatility and sluggish global GDP growth. The low level of rates is still here for some time to come, especially in the context of non-US economies still struggling and experiencing very low levels of inflation.

Australia has not been immune from the global market volatility. Equity markets were extremely weak in January followed by poor credit markets in February with the added worry of some European banking concerns. However, markets have recovered well in the past month along with global peers. The most recent Australian GDP data was strong as well as the labour force data exceeding expectations. On the other hand, the recent strong AUD may concern the RBA. Low inflation and a cooling property market gives the RBA room to move, with markets now expecting a 0.25% cash rate cut by the last quarter this year. Australian credit markets have partially recovered in March, however this has been at a mixed pace depending on the market segment. Liquidity factors have been evident with issuance in the listed bank hybrid sector. Of concern is that the wholesale markets have seen no significant non-bank issuance in 2016. This points to a lack of investment by corporate Australia.

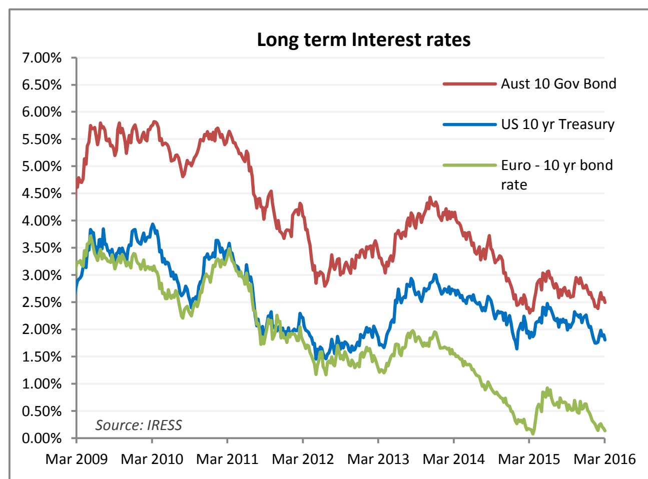
Relevant Australian Interest Rate returns to March 2016 end

Index	1 month Return	3 month Return	12 month Return	12 month Volatility
Cash (Bank bill index)	0.20%	0.58%	2.24%	n/a
UBS Australian Government Bond (All maturities)	-0.36%	2.33%	1.58%	4.10%
UBS Corporate Bond (All maturities)	0.02%	1.42%	2.22%	1.86%
UBS Composite Bond (All maturities)	-0.21%	2.05%	1.97%	3.19%
ASX Bonds and Hybrids; All Issues (incl. franking)*	1.00%	-0.18%	0.15%	2.50%
All Bonds	1.25%	-0.01%	1.68%	2.29%
All hybrids (incl. franking)	0.94%	-0.19%	-0.50%	2.98%
All Ords	4.12%	-3.61%	-12.11%	17.08%
All Ords accum	4.74%	-2.35%	-8.05%	17.20%

** franking including on securities with franking credits attached. Sources: IRESS, EAP.*

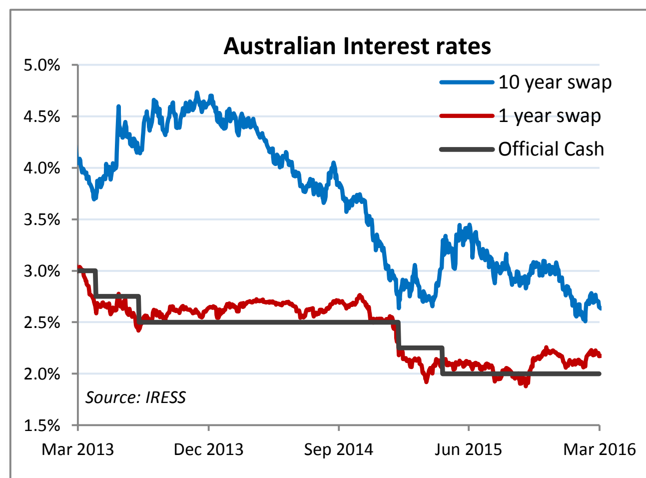
Global Interest Rates

Interest rates globally fell heavily again in the March quarter. In most markets, rates have made new lows, however US rates are more in a sideways trend, indicating that the US economy is faring better than most. Interest rates in Europe are close to zero across the whole curve. Inflation expectations are very low. Combined with weak growth, it is not surprising interest rates remain low and that forecasts of US Fed rate rises have been pared back. Additionally the Fed has made it clear they take into account the state of financial markets and global risks. With the US out of synch with other major economies and other central banks (ECB, Japan) enacting various forms of bond buying policies to stimulate economies, increased inflation will be required to move interest rates significantly higher.



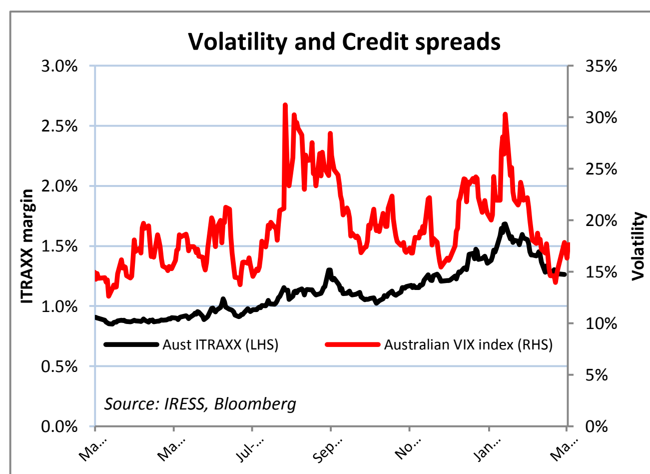
Australian Interest Rates

Australian rates remain low in an environment of low inflation, a rising AUD and signs of the strong housing sector abating. These factors give the RBA (which has an easing bias) room to potentially cut the cash rate in 2016. This will keep pressure on short term rates to remain low. Additional factors to drive interest rate volatility in coming months are the timing of the 2016 Federal election and potential for the global drivers of the recent volatility to re-emerge. The high level of Australian rates compared to that found offshore will keep demand strong for Australian bonds and potentially put more upward pressure on the AUD and in turn the economy. This will also influence the RBA. The market is pricing for a 25 point cash rate cut in August to 1.75%.



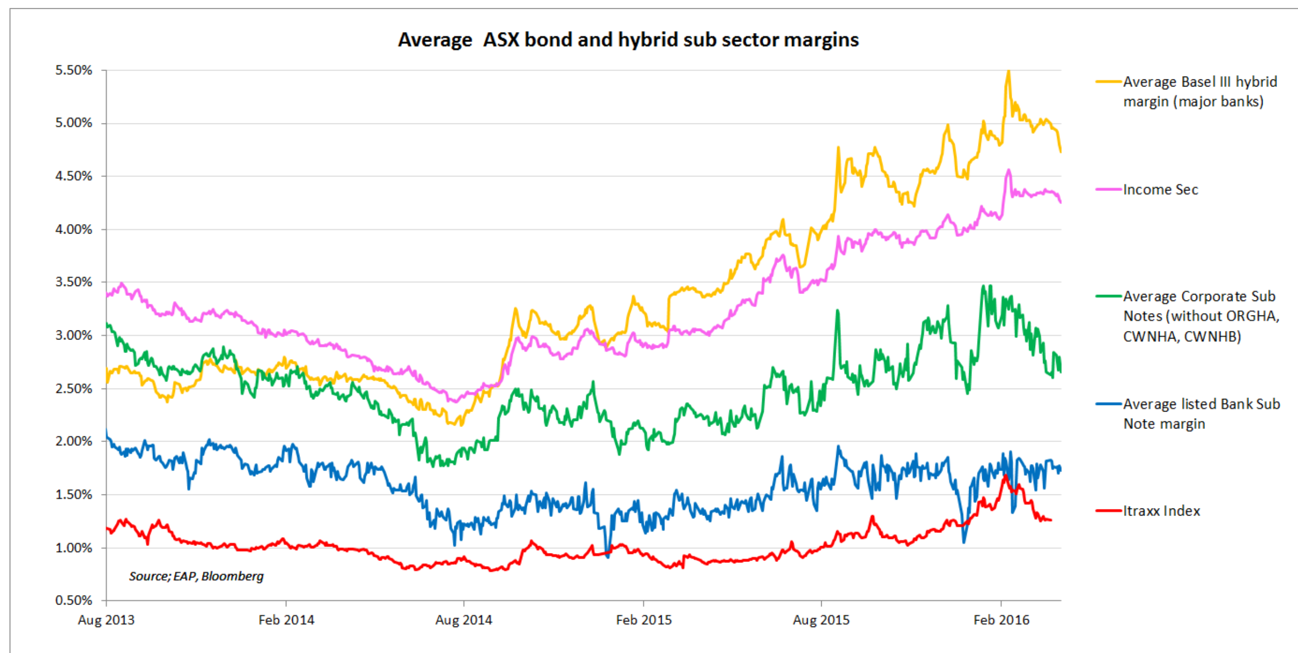
Australian equity market vs. bond and hybrid markets

Volatility in all markets has been elevated in the past quarter. Australian equity volatility surged to levels seen in the previous July, however in contrast this most recent bout of volatility was accompanied by rising credit spreads. This rise was attributable to heavily falling commodity prices and a scare on the balance sheets of European banks. These factors stabilised during March. Combined with a toned down US Fed, markets recovered well, as shown in the chart with volatility and credit spreads much lower at quarter end.

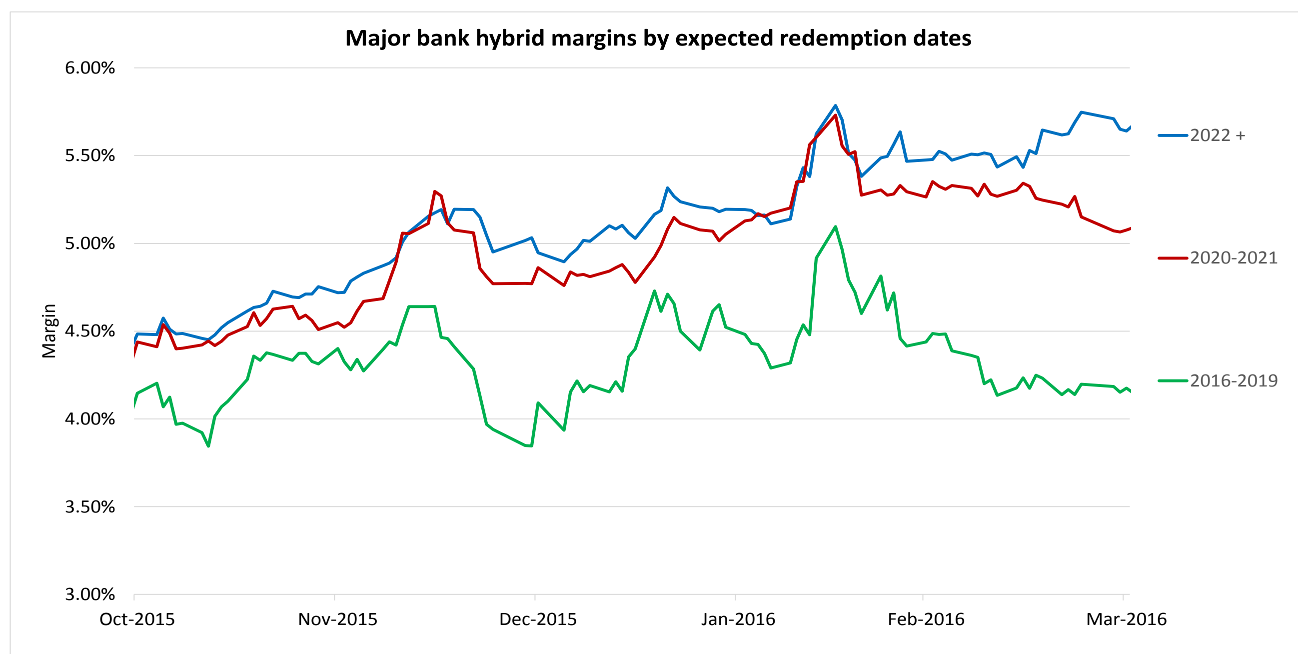


ASX Bond and Hybrid market

Market volatility in the first quarter had a large impact on spreads of ASX bond and hybrid securities, having the effect of continuing the upward trend of margins in the various sub sectors that commenced in August 2014. The late part of the quarter saw credit spreads fall back, following the lead of the reference ITRAXX index. Non-bank corporate bond spreads have recovered best, possibly indicating the lower level of individual company share price volatility compared to the banks. There have been no negative credit events from companies with ASX issued interest rate securities. In late 2015 some doubt was cast on Origin's ability to repay its subordinated notes due late 2016, however more recently the company has satisfied the markets that the repayment will occur. Crown Resorts debt has fallen in price due to press reports that the major shareholder may embark on capital management. Crown Resorts themselves have stated they are unaware of such activity. Close analysis shows that a leveraged buyout of Crown Resorts is very unlikely given governments' requirements that casino operators maintain a high credit grade.



The bank hybrids have reacted differently in the recent recovery depending on the maturity profile. All margin spreads widened in February. However subsequently, as shown in the chart, margins of shorter dated bank hybrids recovered (fell) more quickly than medium and longer dated hybrids. Investors prefer the lower risk profile of hybrids with closer maturity dates.



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