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Australian Fixed Income – What Will 2010 Bring?

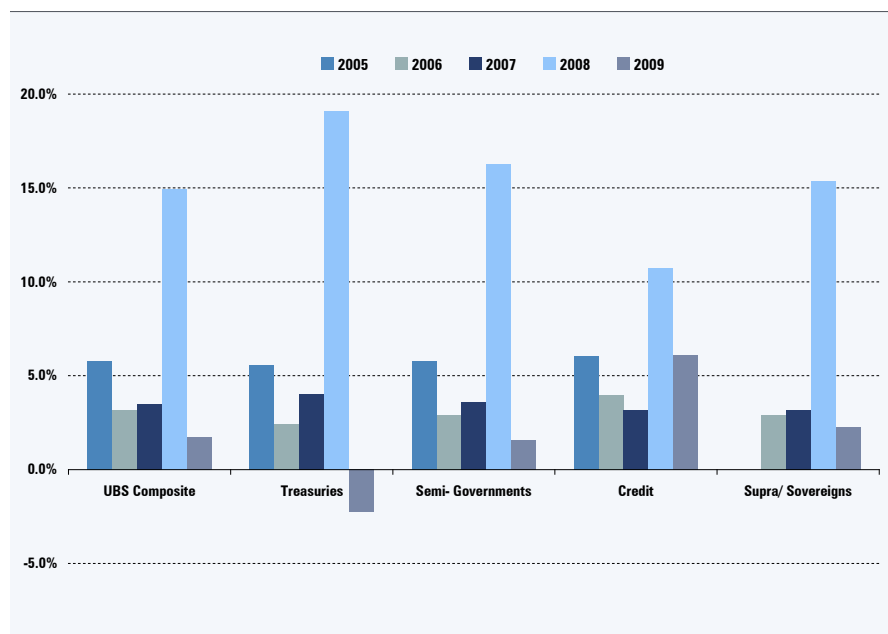
It was always going to be difficult for the Australian fixed income markets to repeat the stellar 15 percent returns of 2008, but the scale of the turnaround in returns in 2009 is likely to have surprised most. If not for the dramatic turnaround in the fortunes of corporate credit through the course of 2009, Australian Fixed Income returns – as measured by the UBS Composite Bond Index – could have had their first negative year since 1999. The year's biggest surprise is almost certainly the pace at which the RBA removed its emergency policy settings employed in late 2008 and the early part of 2009. It is this pre-emptive action which we think positions Australian Bonds for a much better 2010, notably relative to other global bond markets.

2009 in Review

Before exploring the rationale for our 2010 outlook it is worth reflecting on the drivers of the 2009 performance of the Australian Fixed Income market. In the first part of the year performance was dictated by the dramatic easing of monetary policy across the globe which saw domestic interest rates bottom at 3 percent. The scale of this move had largely been captured in the 2008 performance of Treasuries with market expectations at the height of the financial crisis looking to rates falling as low as 2 percent.

However, given the success of the Australian government's fiscal stimulus and the early emergence of the recovery in many of Australia's key trading partners, rates never saw these lows. In fact, these elements required a series of

Figure 1. Performance of the UBS Composite Index Over the Last 5 Years.



Source: UBS Australia.

upward revisions by the market to the scale and pace of the RBA removing the accommodative monetary policy settings through the middle part of the year. Supporting these moves also were the consistently high adjusted inflation readings (despite declining headline numbers) which suggested that when the economy turned inflation could pose a material risk. This saw treasury and semi-government bonds come under significant pressure and in Q2 alone saw longer dated securities losing as much as 8.0 percent.

The sooner than expected economic and market recovery was not all bad news for the

Australian Fixed Income market though, with credit securities enjoying a significant bounce, particularly those in the banking sector. All of sudden the woes that had beset the banking sector over the last 18 months (i.e. funding pressures and rising bad debts) looked like they were beginning to ease. This saw the spreads on the big-4 Aussie banks tighten from the +250bps wides seen in late 2008 to below 100bp in the space of 6 months. Further, corporate issuance volumes (both domestically and offshore) and equity raisings saw dramatic increases and have helped to ease stretched credit fundamentals and refinancing pressures which had been a

significant contributor to corporate spread widening in the first instance.

Relative to other global markets, Australian bonds have underperformed, both in terms of treasuries and credit. The majority of government bond markets around the world have benefited from the aggressive easing earlier in 2009 and the prospect of those low rates remaining low for some time to come. On the credit side Australia has significantly underperformed the global credit returns of 20 percent primarily due to the domestic indices being dominated by highly rated banks and supra/sovereigns that did not face the same scale of defaults and resultant sell-off in 2008, therefore having less ground to retrace.

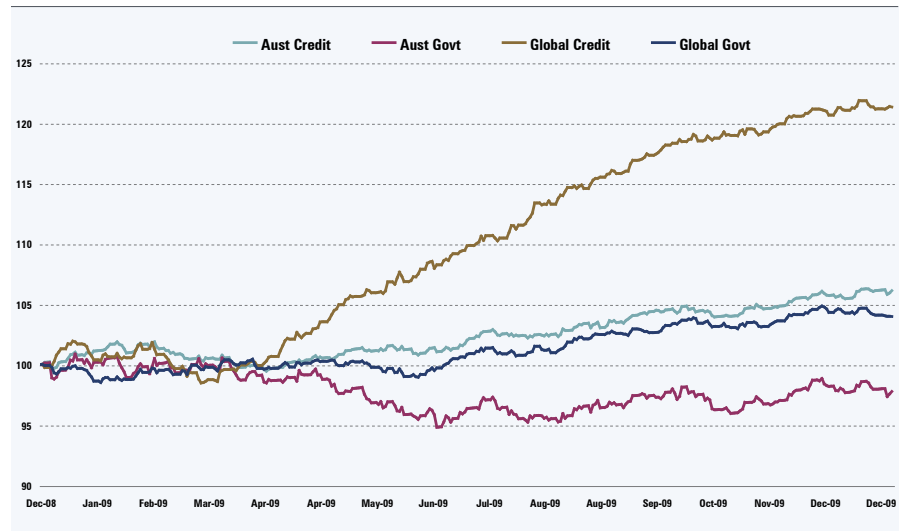
What to Expect in 2010

In summary 2009 was not a great year for Australian bonds in either an outright or relative sense, so should we expect a repeat of this performance in 2010? At first glance it would appear that there are many factors which point to further pressures, most notably the prospect of further rate rises by the RBA over the next 12–18 months. Increasing issuance in the treasury and semi government markets is also likely to add further pressure to yields. Also, credit spreads have largely retraced most of their 2008 losses to be trading at near longer term historical averages, likely indicating the potential for spread contraction is far more limited in 2010.

Although all of these factors should point to increased pressures for Australian bonds, we think that when looking at these factors in regard to how much is already priced into present valuations and their position relative to other global bond markets, we think the outlook is somewhat brighter.

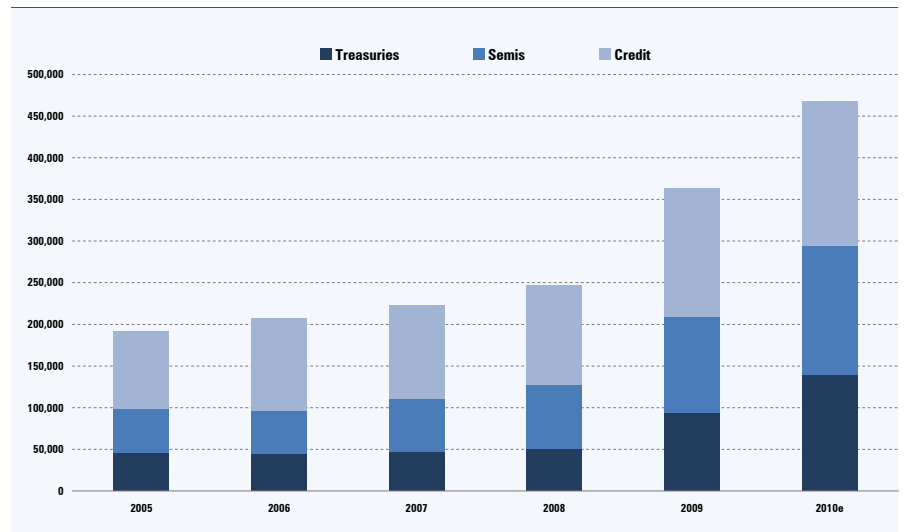
First let's look at the potential for the RBA to increase interest rates in 2010. Given the state and relative health of the Australian economy, the RBA will undoubtedly look to tighten monetary policy over the course of 2010 as it tries to return interest rates to more normalised settings and contain the threat of an outbreak of inflation. As to what level this might be is currently being debated by economists, but it does not seem unrealistic to assume a level around 5 percent. Then if we take a look at current market pricing,

Figure 2. Australian Treasuries and Credit v global Treasuries and Credit in 2009.



Source: UBS Australia Ag and Barclays Capital.

Figure 3. Developments in the Size of the Australian Bond Market Over the Last 5 Years.



Source: 2005 to 2009 actuals sourced from UBS Australia and 2010 estimate derived from JP Morgan forecast.

for instance 12-month futures implying a rate of 4.9 percent and 3-year futures priced at 5 percent, then it appears markets have largely pre-empted the RBA's course of action through 2010. We are therefore looking to a much more gradual upward drift in yields over the next 12 months, rather than the dramatic re-pricing of interest rate expectations witnessed in Q2 2009.

A factor which is somewhat harder to gauge is the impact of increasing issuance. Relative to the last 5 years, 2009's gross and net issuance of A\$51bn and A\$45bn doubled the size of treasury out-standings in the market, and with JP Morgan forecasting a

further A\$46bn of issuance in 2010, the size of the market is set to have almost tripled to just over \$140bn. These numbers relate only to the treasury market, but assuming the semi government market also increases at the same rate as in 2009, we could see government and semi government issuance at just under A\$300bn, by end-2010.

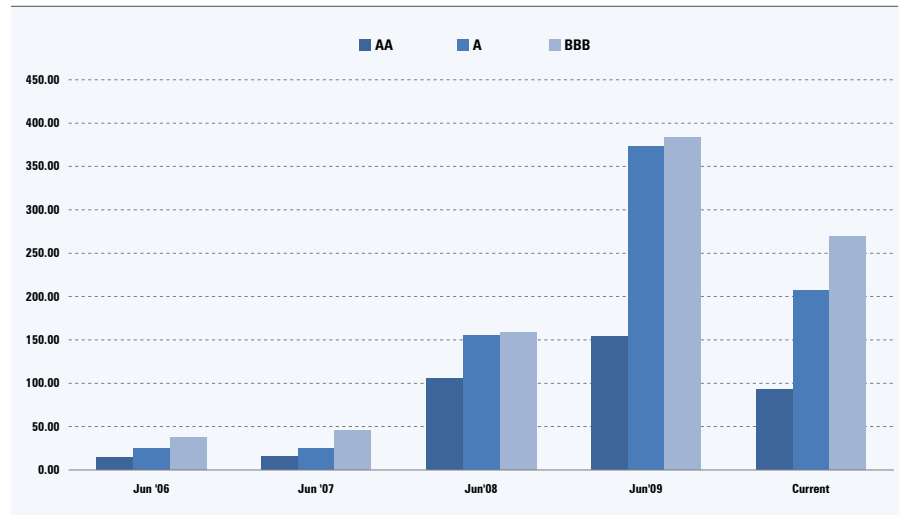
At face value, the relative increase in issuance is large, but needs to be considered in the context of the dearth of government issuance in the years prior to 2009 and also the scale of government bond issuance round the rest of the world. On this latter point, in 2009, total government bond

net supply amounted to US\$2.7trillion, with 2010 expected to see a similar number again. The US, EU and Japan dominated supply volumes in 2009 and are expected to do so again in 2010 and beyond, seeing their index weights increase further. We therefore think it is developments in these countries/ regions that will frame the 2010 supply/ demand dynamic, not Australia's 1 percent (and declining) share of net expected supply.

Whilst we have a reasonable picture of the expected supply outlook the demand picture is somewhat more clouded. We can point to continued demand from foreign central banks, ongoing purchases by bank balance sheets and possibly improved household demand, but whether the scale of this demand will support supply is the crucial question. Through 2009 the massive quantitative easing programmes across the US, UK and Japan largely supported that supply, so with these now finished or rolling off demand will need to be compensated from elsewhere to prevent a significant widening of yields. Whether this will occur remains one of the biggest unknowns for 2010, but were yields to come under pressure, government support is likely going to be required to be re-instated to ensure ongoing debt management costs remain manageable.

In Australia specifically, the scale of demand also remains in question but we see two potential sources of new or increased demand. The first factor is the removal of interest withholding tax which was brought into law in late 2009 and is expected to bolster demand for Australian bonds offshore. The second and yet to be resolved factor is the Australian banking regulator's proposed changes on bank liquidity. At present these changes are subject to industry consultation, but even if initial proposals for bank liquidity requirements are only partially implemented, this is likely to lend good support for the government and semi-government bonds. This is unlikely to be unique to Australia as other banking regulators also pursue new liquidity requirements, but when comparing the scale of the Australian banking sectors liquidity requirements to the total size of the government market, the scale of support is likely to be relatively much more significant.

Figure 4. Australian Credit Spread Developments in Recent Years.



Source: RBA.

We highlighted earlier that credit markets were the saviour of Australian bonds in 2009 as spreads retraced much of their 2008 widening. But with spreads having come so far in 2009 to now trade just wide of longer term averages, we expect credit returns in 2010, both global and domestic, to still be solid but more subdued. Further with spreads having come so far, the risk reward profile for credit, notably lower rated names, is much less attractive, particularly when considering the vast array of risks that face the global economy in 2010.

For Australia specifically, whilst the economic outlook remains much brighter and should support spreads at or around current levels, we think they could be vulnerable over the course of the year and somewhat strangely this threat is probably greatest at the top end of the rating spectrum. In our view it is the proposed regulatory changes, withdrawal of the government guarantee, and the very large 2010 funding tasks of Australia's big four banks that pose one of the greatest risks to credit spreads this year. Presently the big four banks account for more than half the value of the Australian credit index's corporate exposure and as such represent a material risk to credit returns in 2010. Further event risk for bondholders could be back in focus as cashed up corporate management teams, having bolstered credit fundamentals, can once again begin to focus their attentions on delivering shareholder value.

Conclusion— A Good Relative Bet

In summary, 2010 is likely to be a solid but hardly stand out year for Australian fixed income. The prospect of further rate rises, increasing government and semi-government issuance, combined with a more benign contraction in credit spreads is likely to see returns again fall short of their longer run average returns of 5.5–6 percent. However, any shortfall is unlikely to be substantive as it appears markets have largely factored in many of these factors for 2010, by pricing in interest rates rising to 5 percent by year-end. So if we conservatively factor in slightly higher yields from where we are now, we think 2010 Australian bond total returns are set to show a significant improvement over 2009.

In this context Australian bonds probably are unlikely to appear all that attractive on a standalone basis, but when considered in the context of a broader global fixed income portfolio it is here where we think they offer the most appeal. In most developed markets round the world - particularly those that account for the largest parts of the global bond indices - the prospect of;

- longer term economic recoveries despite current pressures,
- eventual rises in interest rates from near zero levels, and

— huge government issuance programmes (that dwarf Australia's anticipated issuance programme), positions Australian bonds favourably over the short to medium term. Accordingly, we would expect Australian bonds to reverse their 2009 underperformance, seeing them deliver excess returns over most other developed global bond markets over at least the next 12 months.

We would add however that this scenario is premised on a slow and gradual recovery in the global economy but should we be faced with another negative shock/ economic downturn we think this is likely to place Australian bonds in an even stronger position. Having moved proactively to reduce the emergency settings, relative to other central banks around the world, the RBA now has significantly more flexibility to address such challenges. Were more intervention be required to stem a downturn, Australia could turn to monetary policy to provide relief where as nations with near zero interest rates would be required to revive quantitative easing programmes or fiscal stimulus.

Such a scenario only serving to increase further the already huge deficits and debt burdens they already face. We also think that the increasingly 'defensive' composition of the Australian bond index – whereby treasuries, semis and other AAA rated paper account for 77 percent - relative to the global bond indices would also aid relative returns.

Conversely - and a scenario which we think is much less likely in the short term - should the pace of economic recovery gather increasing pace, Australian bonds, whilst likely to come under pressure themselves, should again outperform other global bond markets. Presently, short rates in the US, UK and EU are priced for a 'lower for longer' scenario and were the economic recovery to be stronger than expected, short rates would likely see significant pressure as central banks would likely look to move rates sooner than expected resulting in a situation very similar to the sell-off we saw in Australian treasuries in Q2 2009.

The biggest risk however is if this sharper than expected recovery takes hold in the Asian region, and fails to impact other developed economies. This would leave the RBA in isolation to countries like the US, UK and EU, as they raise rates to stem inflationary pressures. Although distinctly possible, we expect the resultant strength in the AUD, as well as continuing calls for a cooling of the Chinese economy and a revaluation of the currency there is likely to reduce the likelihood of such an outcome, at least in the near to medium term.

So whilst we can't be confident about the outcomes for the global environment for 2010, one thing that we do have a high degree of conviction in is the superior risk return profile of Australian bonds relative to other developed country bond markets. So, whether the economy continues to improve gradually or surprises on the up or downside, we think an overweight exposure in Australian bonds in the context of a global bond portfolio should help investors outperform in the years to come. ■

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