The Floating, The Fixed and The Resilient

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Q2 2023 was a strong quarter for Australian senior unsecured floating rate notes. Conversely, it was a tough quarter for other fixed income securities, both domestically and globally, as inflation continues to print stronger for longer, and central banks globally continue to tighten monetary policy to combat elevated core inflation.

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Adding to this sticky inflation scenario, yield curves have been forced to reverse near-term anticipated recessionary pricing, as persistent economic data reflects a resilient consumer in the face of higher borrowing costs.

Credit spreads performed well over the quarter. The Australian money market is flush with liquidity. Banks are increasingly paying up for funding as some of the extraordinary Quantitative Easing measures implemented by the Reserve Bank of Australia (RBA) are rewound. However, the glut of senior unsecured bank issuance that was predicted by some to fund Term Funding Facility maturities has not eventuated. What has permeated through the Australian money market has been selective issuance by banks outside of the major four, whereby covered notes with a soft bullet maturity have been offered via the primary market. Although issuance of this style hasn't been substantial during Q2, it has been interesting to see banks using their name, and not the name of a structured note, to print debt that is covered, or backed, by RMBS assets.

The term 'resilient' has been used by the Federal Reserve several times during Q2 to describe the spending and consumption patterns of the US consumer. From a domestic perspective, consumer spending has been stronger than expected, particularly in the services sector of the Australian economy. Coupled with an unemployment rate that is still well below 4% mid-way through 2023, and on the back of consistent monetary policy tightening from the RBA since May 2022, suggests that the Australian consumer is equally resilient[1].

From a fixed income perspective this resilience is not what economists were predicting coming into 2023, and economic commentators were adamant that the second half of 2023 would be characterised by widespread technical recessions, stagflation and monetary policy easing by many central banks. This scenario has thankfully not eventuated and yield curves were forced to reprice and move higher across the curve. If unemployment continues to remain near historic lows over the medium-term, or even moves up toward 4.5% over the coming 12-18 months, as the RBA correctly points out and indeed forecasts, this will still be markedly stronger than where the domestic employment data was printing pre-COVID. Add to this a RBA that is determined to engineer a soft landing for the economy whilst still tightening interest rates further, it seems logical to anticipate higher yield curves in the short- to medium-term. Credit spreads on the other hand seem well positioned to strengthen as primary issuance is actively sought by the market. Credit events, similar to Q1 which bore witness to regional banking wobbles in the US and the forced merger of a large European bank, appear to be thankfully behind us.

The portfolio outperformed the index over the quarter whilst maintaining an average credit rating of AA-/A+.

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[1] Bloomberg Finance L.P., as of June 2023

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