Floating Rate Coupons Blast Off

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Despite challenging market conditions, the floating rate segment remained liquid and continued to trade well in the second quarter of 2022. Moreover, expectations of interest-rate hikes lifted coupon levels to their highest in years.

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Policy Tightening Boosts Australian Floating Rate Coupons

The second quarter of 2022 followed a similar theme to the first three months of the year, with substantial volatility across most asset classes. And although the spreads in major-bank senior unsecured notes continued to widen, they eventually began to stabilise towards the end of June. However, the coupons on Australian dollar (AUD) floating rate notes increased markedly when the Reserve Bank of Australia (RBA) began aggressively tightening monetary policy.

Bond Issuance Initially Drove Spread Widening

Credit spreads continued to drift wider during the second quarter. Yet, this was not driven by market dysfunction or illiquidity but rather the knock-on effect of fresh bond issuance in the primary market.

This development followed the theme set in the first quarter when banks, compelled to issue bonds amid volatile conditions, needed to offer additional spread concessions to attract investors. This primary issuance was also a reality check for some credit curves that had been bid due to a lack of supply and were subsequently forced to reprice in line with cheaper new issuance.

Widening Credit Spreads Abate

Spreads also found it hard to rally due to swings in market sentiment, from a sell-off on the back of inflation data to gains underpinned by a belief that central banks would aggressively raise interest rates to contain inflation at the expense of a global recession.

All the while, the floating rate market remained liquid and continued to trade well, despite the substantial challenges triggered by the war in Ukraine and a sharp rise in inflation data across the US and Europe.

As mentioned, spread widening appeared to slow towards the end of June due to substantial repricing of the Bank Bill Swap Rate (BBSW) curve[1] and aggressive pricing-in of near-term interest-rate hikes by the RBA.

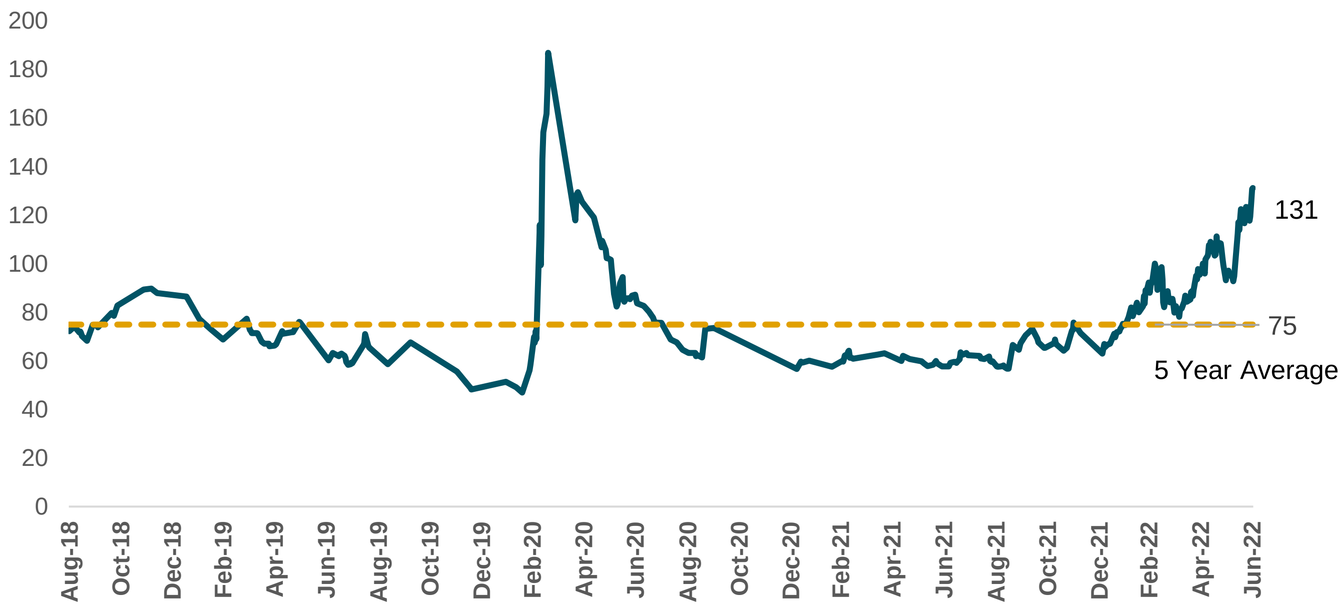
Floating Rate Notes Shine Amid Expected Rate Hikes

Owning a floating rate coupon can be beneficial in times of significant monetary-policy tightening. To put this in perspective, the 3-month BBSW rose from 0.23 per cent at the end of March to 1.81 per cent at the end of June.[2]

The uptick in both the RBA cash rate and the pricing of additional near-term interest-rate hikes by the RBA has allowed coupons on floating rate notes (FRN), which are reset each quarter, to lock in at levels much higher than those recorded in recent memory.

Generating such a notably high coupon would allow some market volatility to be absorbed or offset through daily coupon accruals. In contrast, this wasn't the case in early 2022, when markets started to sell off, and coupons on FRNs in the AUD senior unsecured segment were priced at BBSW levels that were close to zero.

Figure 1: Markit iTraxx Australia IG Spread (bps)



Source: Bloomberg Finance L.P., as of 1 July 2022. Past performance is not a reliable indicator of future performance.

Footnotes

[1] The Bank Bill Swap rate is a short-term interest rate used as a benchmark for pricing Australian-dollar derivatives and securities

[2] Source: Bloomberg Finance L.P., as of 30 June 2022.

Important Disclosures

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