STATE STREET GLOBAL ADVISORS

Is Now a Good Time for Floating Rate Notes?

Srinivasan Margabandu, Fixed Income Portfolio Specialist

- Higher yields are increasingly likely with steeper government bond curves expected in 2022, leading to potential underperformance of fixed rate bonds.
- Australian markets pricing in earlier hikes and central banks have changed stances quickly, leading to spikes in bond volatility.
- Floating Rate Notes (FRNs) provide enhanced income compared to cash/short term deposits, are a good way to access lower volatility income than fixed rate equivalents and credit fundamentals of banks, which mostly issue FRNs, have been robust.

As we approach the end of 2021, a handful of themes have remained common across global financial markets; the sharp recoveries out of the COVID induced recession, inflation overshooting central bank targets, and tight labor markets as well as lack of spare capacity generally have all led to the closure of estimated output gaps. Central banks have started to realise that recent spikes in inflation could prove more persistent than first expected, with the bout of higher realised inflation having shifted most market and survey based measures of inflation expectations higher, and have begun a transition towards tighter financial conditions. All of this has led investors to re-evaluate key risk measures such as real yield, term and inflation risk premia, thereby resulting in expectations of higher yields and steeper curves for most government bonds in 2022.

In Australia too, most economic forecasts have been upgraded with stronger activity expectations boosted by a rebound in household consumption given the high savings rate, ongoing fiscal support and the underlying strength in labor markets. In its latest statement on monetary policy in November 2021, the Reserve Bank of Australia (RBA) forecasted a rapid bounce back in aggregate demand, with GDP forecast to grow by 5.5% over 2022, up from previous expectations of 4.25%, and similarly inflation expectations for 2022 raised to 2.25% over 2022 (from 1.75% previously)[1]. This reflects the stronger outlook for housing costs, and a steady pick-up in wage growth. Survey based indicators such as Purchasing Managers Index (PMI), consumer and business confidence levels, as well as leading economic indicators all point to a strong rebound in activity as lockdowns are lifted. The RBA left the policy rate (cash rate) at a record low 0.10% in its December policy meeting, and has pledged not to tighten policy until actual, not forecasted inflation, is within the central bank's 2-3% target.

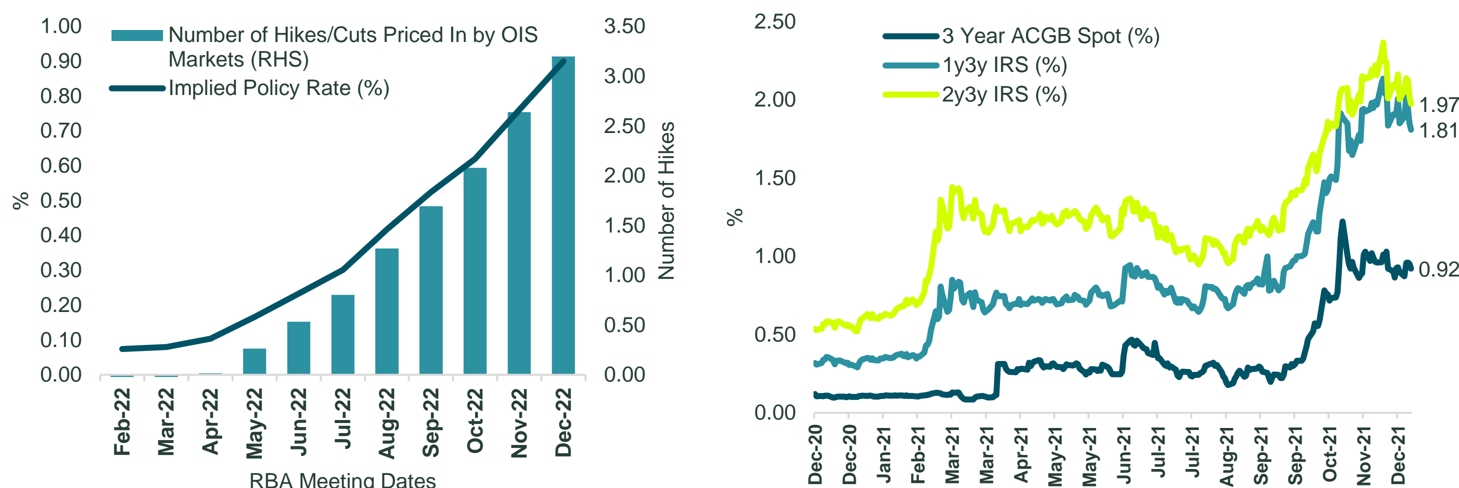
Markets however expect the RBA to taper its bond purchases after the next review meeting in February 2022, and market expectations for the cash rate to be increased have risen also driving expectations for a broader move higher in yields (see figure 1). The expected timing of the first cash rate increase is now around mid-2022, and OIS prices imply that market participants expect the cash rate to increase to around 1% by end of 2022, and 1.7% by the end of 2023. While this might appear aggressive, and it may take time for a stronger economy to translate into increased price pressures - risks for earlier normalisation do remain, and we have seen central banks change course quickly, as we saw with the Fed in November; the month began with a relatively dovish Federal Open Market committee, but as inflation readings remained quite elevated, commentary from the Fed became progressively more hawkish, culminating with Chair Powell on November 30th stating outright that the Fed may consider ending tapering asset purchases early. The recent strong US Consumer Price Index (CPI)

[1] Source: RBA as of 4 Nov 2021.

print (6.8% yoy in November, largest 12 month increase since 1982[2]) will now embolden the Fed more to indicate a steeper path of rate hikes.

There are increasing chances therefore of duration risk being much less rewarding in 2022 in Australia as well - especially when taken into account the potential volatility from a steepening Australian interest rate curve as the RBA tries to hold on, while the macro backdrop continues to turn less supportive for government bonds. The RBA has already purchased ~A$330bn of bonds since March 2020 and holds ~33% of outstanding Australian Commonwealth Government Bonds (ACGBs). The ongoing A$4 billion a week of bond purchases from the RBA have led to net negative supply in the market and helped depress term premia, but supply technicals are expected to turn negative from February 2022, and issuance will gather pace in 2022, even after accounting for lower-than-budgeted supply on the back of better revenues.

Figure 1: Markets are Pricing Earlier Hikes Than RBA Expectations, and There Has Been a Sharp Uptick in Government Bond Yields



Source: Bloomberg Finance L.P., as of 10 December 2021.

Given this background of potential volatility, now would appear to be an opportune time to consider an increased allocation to Floating Rate Notes for investors:-

(i) who want to pivot into a defensive duration position to protect themselves against potential rising rates and associated volatility

(ii) who want to pick up additional yield with a relatively small increase in risk, compared to cash/term deposits

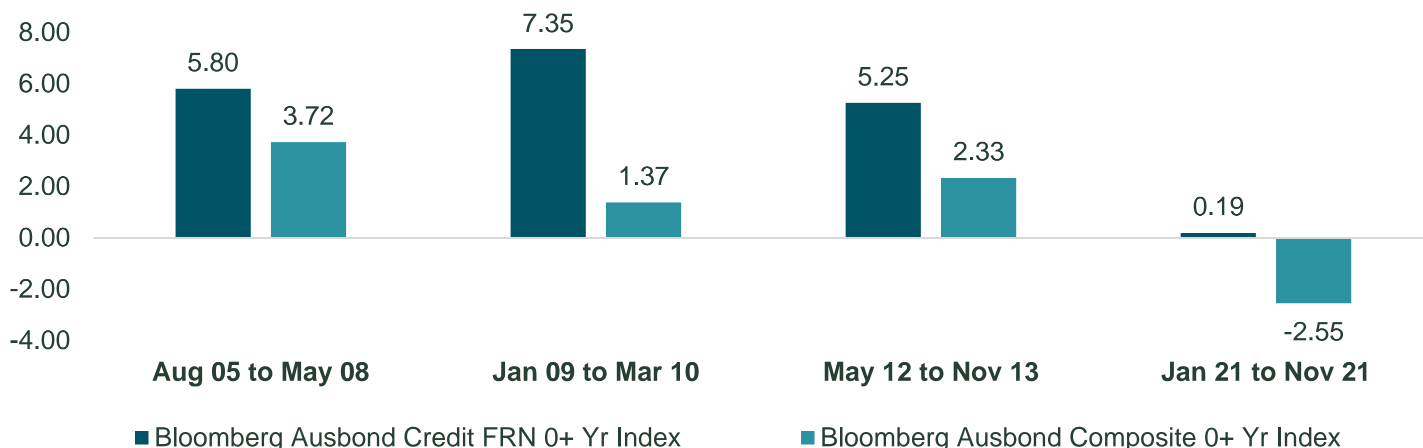
(iii) who want to have a lower beta inflation hedge providing good reward-to-risk compared to other asset classes.

Australia's FRN market is composed of Investment grade quality bonds issued by corporate entities - predominantly domestic and foreign banks and other lending institutions (almost 92% of the FRN market), government owned entities, and Australian listed property trusts, with most paying income set at a margin over the bank bill swap rate (BBSW). Australian banks and financial institutions' overall funding costs remain close to historic lows, notwithstanding the recent rise in yields, and the Term Funding Facility has provided banks with low-cost funding for three years, and so will continue to support low funding costs until mid-2024. In addition, banks' funding costs have also benefited from the strong growth in low-rate deposits over the past year or so. Credit growth has been strong, around 7.5% in September 2021 (6m annualized) [3] - close to 6 year highs, driven

[2] Source: US Bureau of Labor Statistics as of 10 Dec 2021.
[3] Source: RBA, as of 4 Nov 2021.

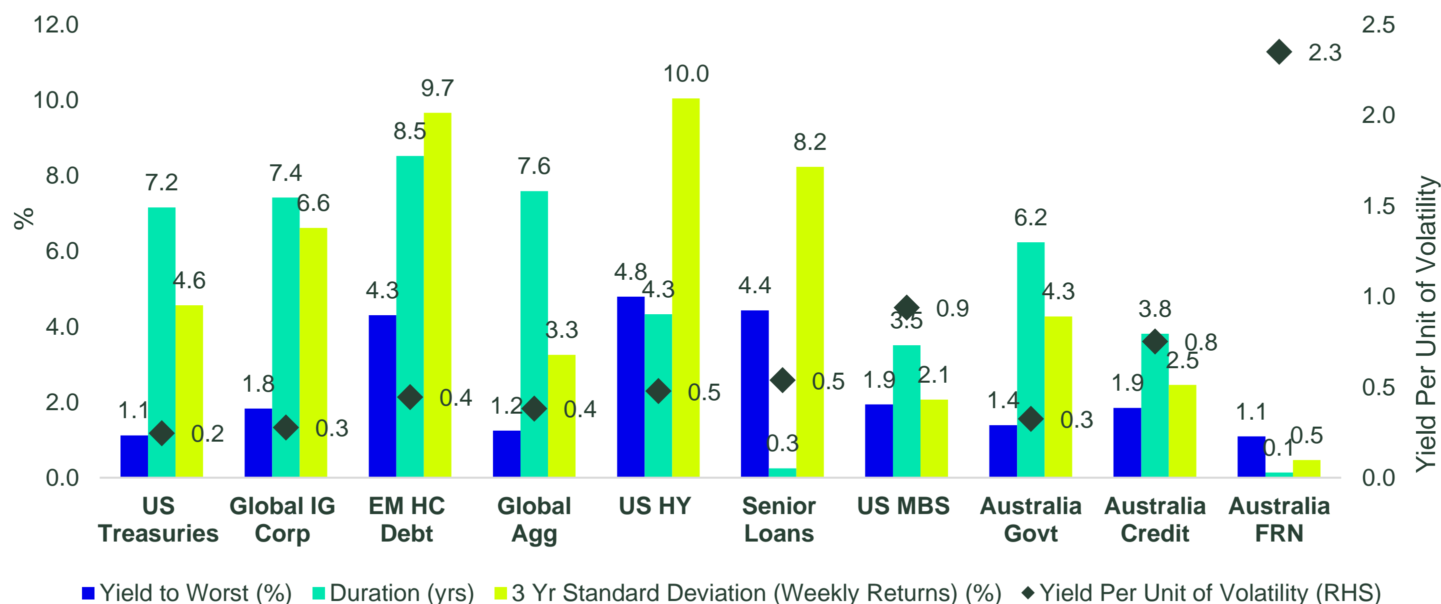
by faster growth in housing and business credit. Syndicated lending to large businesses has picked up to be well above its average pace over the past decade as well. All this has led to the financial sector (S&P ASX 200 Financials) outperforming the broader market (S&P ASX 200 Index) in the last 1 year[4], with a number of financial institutions benefiting from decreased provisions for credit impairments, in line with the improved economic outlook. FRNs have outperformed fixed rate bonds in all periods of rising rates (see figure 2), have provided a very stable source of income and return (see figure 3), and the recent widening of discount margins provide an attractive entry point for investors who have been on the sidelines.

Figure 2: Returns Comparison Over Periods of Rising Rates (Returns Over 1 year are Annualised)



Source: Bloomberg Finance L.P., as of 30 November 2021. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

Figure 3: Even at Low Yield Levels, FRNs Offer Better Yield Per Unit of Risk Compared to Other Bond Market Segments



Source: Bloomberg Finance L.P., Credit Suisse as of 30 November 2021.

[4] Source: Bloomberg Finance L.P., as of 10 Dec 2021.

Important Disclosures

Issued by State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services Licence (AFSL Number 238276). Registered office: Level 14, 420 George Street, Sydney, NSW 2000, Australia T: +612 9240-7600. F: +612 9240-7611.

The views expressed in this material are the views of the SSGA Fixed Income Strategy Team through the period ended 10 December 2021 and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

This material is general information only and does not take into account your individual objectives, financial situation or needs and you should consider whether it is appropriate for you.

Investing involves risk including the risk of loss of principal.

Floating rate securities are often lower-quality debt securities and may involve greater risk of price changes and greater risk of default on interest and principal payments. The market for floating rate securities is largely unregulated and these assets usually do not trade on an organized exchange. As a result, floating rate bank loans can be relatively illiquid and hard to value. Investing involves risk including the risk of loss of principal. Diversification does not ensure a profit or guarantee against loss.

The value of the debt securities may increase or decrease as a result of the following: market fluctuations, increases in interest rates, inability of issuers to repay principal and interest or illiquidity in the debt securities markets; the risk of low rates of return due to reinvestment of securities during periods of falling interest rates or repayment by issuers with higher coupon or interest rates; and/or the risk of low income due to falling interest rates. To the extent that interest rates rise, certain underlying obligations may be paid off substantially slower than originally anticipated and the value of those securities may fall sharply. This may result in a reduction in income from debt securities income.

Bonds generally present less short-term risk and volatility than stocks but contain interest rate risk (as interest rates rise bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment.

Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks but provide lower potential long-term returns.

BLOOMBERG and BLOOMBERG INDEXES are trademarks or service marks of Bloomberg Finance L.P. Bloomberg Finance L.P. and its affiliates (“collectively, “Bloomberg”) or Bloomberg’s licensors own all proprietary right in the BLOOMBERG INDEXES. Bloomberg does not approve or endorse this material and disclaim all liability for any loss or damage of any kind arising out of the use of all or any part of this material.

This document may contain certain statements deemed to be forward-looking statements. All statements, other than historical facts, contained within this document that address activities, events or developments that SSGA expects, believes or anticipates will or may occur in the future are forward-looking statements. These statements are based on certain assumptions and analyses made by SSGA in light of its experience and perception of historical trends, current conditions, expected future developments and other factors it believes are appropriate in the circumstances, many of which are detailed herein. Such statements are subject to a number of assumptions, risks, uncertainties, many of which are beyond SSGA's control. Please note that any such statements are not guarantees of any future performance and that actual results or developments may differ materially from those projected in the forward-looking statements.

All material has been obtained from sources believed to be reliable. There is no representation or warranty as to the accuracy of the information and State Street shall have no liability for decisions based on such information.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without SSGA Australia's express written consent.

Tracking Code: 3985703.1.1.ANZ.RTL
Expiry Date: 31/12/2022