Lockdowns Out, Inflationary Pressures In?

- Australian floating rate securities continue their impressive returns in Q3 2021.
- RBA continues to advise interest rates will be lower for longer until inflation targets are met.
- With rates low, the market will likely start to re-price longer dated bonds. Will this re-pricing see an increased appetite for floating rate coupons rather than fixed?

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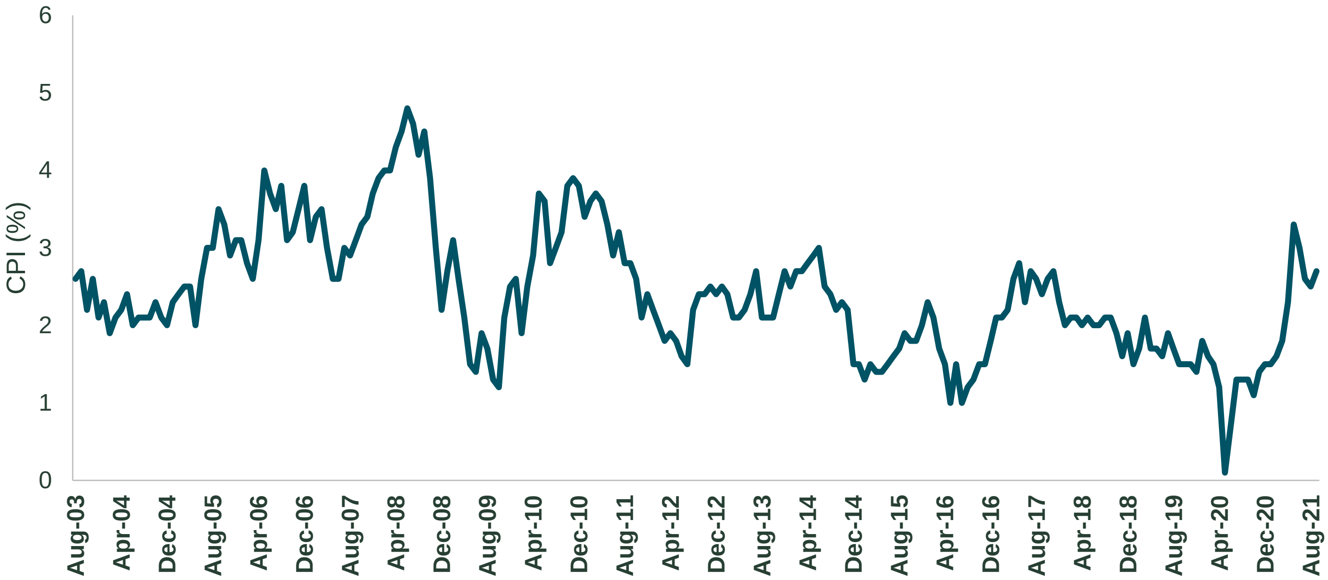
The September quarter of 2021 yet again proved positive for senior unsecured bank floating rate notes. The usual fickle market conditions reared their head going into 30 September as several of the major four banks positioned their trading books for financial year end. This weakness was only marginal however as traders moved spreads higher in what appeared to be a reluctance to add new positions to their inventory as financial year end approached.

The major theme of the last three months has been a concerted focus on messaging from central banks. In particular the consistent theme of many central banks both discussing and highlighting to the markets globally that stimulus is being withdrawn... gradually. Tapering is likely to come in 2021. To be more specific, Governor Lowe is still at pains to illustrate to the market that the official cash rate, from what the Reserve Bank of Australia (RBA) is seeing, will remain at 0.10% until at least 2024. Until Australia has continued to reduce its unemployment rate to something between 3-4%, the RBA does not expect to see wage inflation which will drive higher consumer prices until 2024. However the tapering delivered by the RBA in September (weekly bond buying reduced form A$5billion per week to A$4billion per week until February 2022) and other central banks discussing reduced bond buying too should not be confused with higher short term official cash rates. The central banks are reducing the bond buying / the unconventional monetary policy stimulus delivered globally on the back of the Covid-19 pandemic rearing its ugly head in early 2020. With vaccination rates increasing globally and many economies re-opening, central bankers with Governor Lowe included, have been very transparent in guiding the market toward the reasoning behind reducing the bond buying but also at letting that market know that interest rates will be lower for longer until such time as inflation targets are met.

So with interest rates pegged at near zero for the foreseeable future, it makes sense that the market will start re-pricing longer dated bonds as the consistent bid from the RBA is reduced, but also because if interest rates are staying at 0.10% for another two years plus in Australia, and if the central bank is seeing economic indicators that warrant reducing quantitative easing, then maybe we are going to start seeing inflation. This repricing could see an increased appetite form the market for floating rate coupons rather than fixed.

Figure 1: Consumer Inflationary Expectations are Approaching pre Covid-19 Levels

Melbourne Institute Experimental Inflation Gauge (Year on Year) Index



Source: Bloomberg Finance L.P., as of 30 September 2021.

Consumer Prices (CPI) are a measure of process paid by consumers for a market basket of consumer goods and services. The yearly (or monthly) growth rates represent the inflation rate.

As discussed in the June Market Insight, the Term Funding Facility was retired on 30 June by the RBA and the expectation within the market was that now the banks will be forced to issue bonds into the primary market. This expectation was realised over Q3, and although limited, the market did see both domestic and international banks price bonds in the 3 and 5 year space. This welcome new supply of paper was very aggressively sought by the market and is hopefully a sign of further issuance over the medium term. Concerns about potential supply not being able to be absorbed by the Australian money market seem a little premature as banks are also tapping off-shore markets for funding, and given the huge surplus of daily cash balances in the Australian money market, demand from balance sheets and funds will not be an issue.

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