State Street Floating Rate Fund

1 + 2 + 1'ish ≠ 1.85

- Fixed rate yields to continue pushing higher
- Reserve Bank of Australia (RBA) Term Funding Facility (TFF) to stop mid-year
- Floating rate issuance to pick up

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This insight will attempt to propagate, or plant the seed at least, that a 10 year Australian government bond yield at current levels is expensive, and that a floating rate exposure could be warranted. As at 31 March 2021 the Australian 10 Year Government Bond (10 Year ACGB) was yielding 1.8478% hence the numeric title for this piece, which I will explain.

Market practice breaks a benchmark yield curve into two sectors. The first ~3 years are where the money market forecasts central bank interest rate policy and anticipated official cash rates. The longer part of a benchmark curve, which is where the 10 year bond yield reference above fits into, should determine a yield with a broader focus of factors leading to a traded yield. As a back of the envelope calculation goes, adding a forecast interest rate plus an anticipated inflation rate plus a term risk premia for holding longer dated bonds should allow you to determine a good estimation of what you should pay for a 10 year government bond. Per the title of this commentary, if the interest rate policy per market overnight index swap (OIS) is expected to be pricing over 1% in the medium term, and if inflation is expected by the RBA to be at the bottom of their 2-3% Consumer Price Index (CPI) band by 2024, and if a term risk allowance of 1% is also discounted to the formula, that gives you 4.00%. It does not add up to 1.85% which is where 10 Year ACGB's were trading at the end of March. This is a big move from the current yield of 1.85%. It likely won't happen overnight, but to acknowledge that given any unforeseen new pandemic or global shock to the Australian economy, its anticipated growth, the impressive employment momentum and an inflation forecast that the RBA has worked to stoke for many years, shortening the interest rate risk of a bond fund may be deemed palatable at some point.

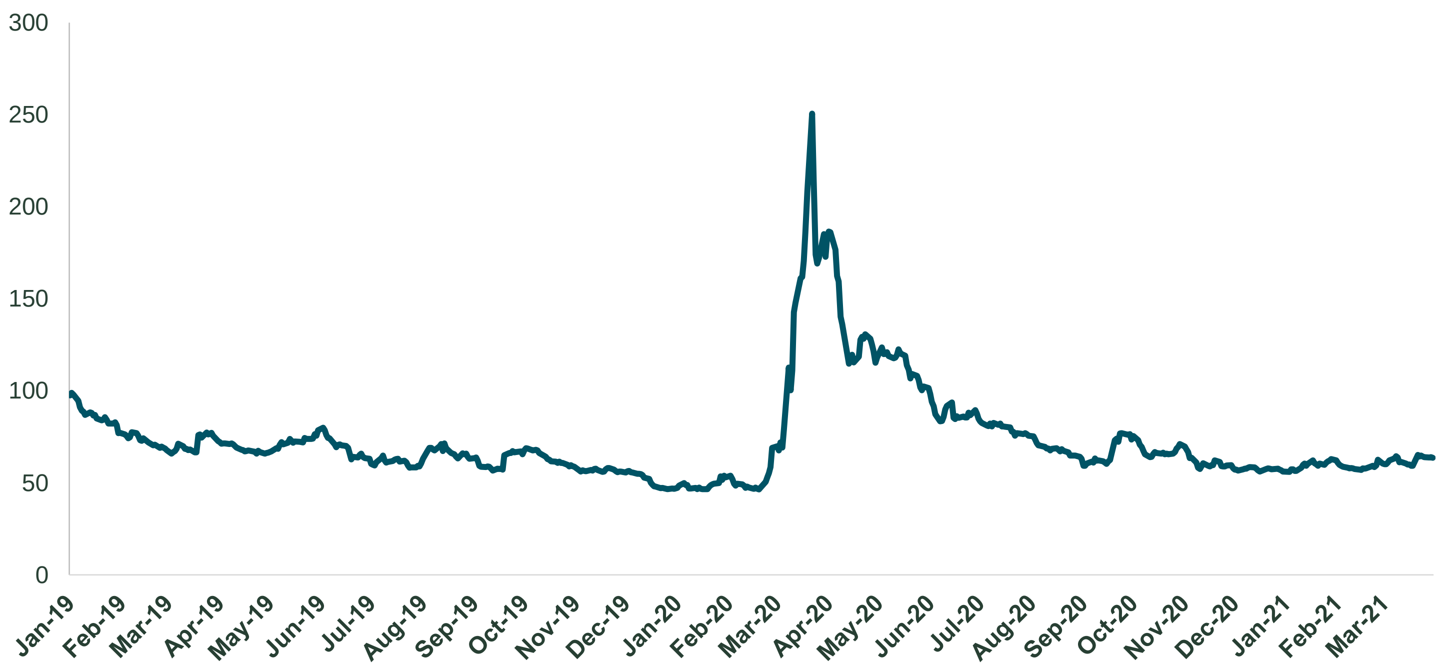
The first quarter of 2021 was a tough market for domestic bonds. The repricing of the 10 Year ACGB over this period is attributable to a renewed focus on reflation. The Bloomberg Ausbond Composite 0+yr Index was down over ~3.30%. Similarly it was a tough period for both credit and cash markets. There are signs that the worst of the COVID-19 pandemic is over in those countries administering COVID-19 vaccines en masse. Most central banks globally are continuing to add liquidity to their respective money markets in a focused drive to both add stimulus to economies constrained by COVID-19 lockdowns and closed borders, but also with the unfaltering mandated focus of spurring inflation. High quality senior unsecured bank credit continued to deliver positive returns over the period, and owning floating rate bonds rather than fixed rate ensured that the State Street Floating Rate Fund did not partake in the negative marks many fixed funds were hit with.

The next three quarters of 2021 will be very interesting for the Australian money market and primary issuance in particular. It seems clear that the RBA will maintain a dovish stance and remain very focused on reducing the unemployment rate. It is then, Governor Lowe explicitly states, that if the Australian unemployment rate approaches 4% that we will start to see the uplift in CPI that is inflation. An unemployment rate target of 4% may seem very low, but bear in mind it is only 12 months since the COVID-19 lock down began in Australia that saw unemployment spike by more than half a million new jobless claims alone in May 2020, yet in February 2021, the unemployment rate has already fallen from 6.3% to 5.8%.

Finally, in so far as issuance, the RBA is set to turn off the TFF in June. Australian banks have had the ability to access three year secured funding from the RBA's TFF at a cost of 0.10%. Justifiably, there has been a limited need by most Australian banks to issue 3 year or less debt in the market. The second half of 2021 should see a primary debt market come to life with both domestic and international banks unable to access the closed TFF and having to go to the market for funding. This will bode well for adding new issues, new banks and additional yield to the portfolio, as banks are forced to pay up for funding in what should prove to be a highly competitive space.

As at the end March, the portfolio continued to hold only senior unsecured bank notes in AUD that had an average credit quality of A+/A, the fund was running spread duration just shy of 3 years and outperformed the RBA Cash Rate Total Return Index (TRI) Index over the period.

Figure 1. **5 Year iTraxx Spreads, 2 January 2019 to 31 March 2021**



Source: Bloomberg Finance L.P., as at 31 March 2021. Past performance is not a reliable indicator of future results.

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