PERENNIAL FIXED INTEREST

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What's really driving the decline in Australian bond yields?

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Recently we have seen the rally in global bond yields gain further momentum in the wake of the massive Quantitative Easing (QE) programme announced by the European Central Bank (ECB). This programme, if anything, exceeded even the more optimistic expectations which will see the ECB purchase $60 billion of fixed income assets on a monthly basis lasting at least until September 2016. Whether the programme runs beyond this point will depend on the impact it has on the growth prospects for the Euro region and importantly on the level of inflation and longer term inflationary expectations. A significant component of these purchases will comprise of sovereign bonds (approximately 75%) but will also include supras, covered bonds and asset backed securities. Assuming QE does finish on schedule, the total amount of asset purchased will exceed a staggering $1 trillion.

Since QE was announced, we have seen global bond yields plummet to new lows with its impact cascading well beyond the Euro region. German 10 year bonds are currently trading at close to 0.30%, by far its lowest level on record. The same is true for almost every country across the region barring some notable exceptions such as Greece. Similar trends have been evident in the US where, despite the almost consensus view that the US Federal Reserve (Fed) will commence the process of normalising interest rates later this year bond yields continue to hit new lows. The 10 year Treasury rate has fallen by close to 50 basis points since the start of this year to be currently trading close to an all-time low at 1.64%. In Australia, the 10 year bond yield has recently fallen below the current cash rate of 2.5% and is currently yielding around 2.35%. While there is currently much speculation as to whether the Reserve Bank of Australia (RBA) will announce further monetary easing over coming weeks, by any measure, bond yields have reached what most would agree as exceptionally low levels.

A big part of the explanation for the recent decline of bond yields outside of Europe is that with the pool of sovereign debt diminishing as QE programmes are implemented, investors are being forced to look abroad for what may be considered more attractive fixed income opportunities. When assessed relative to the exceptionally low yield on offer throughout Europe, Australia would seem to be an attractive destination. Australia has a relatively low level of debt which underpins the AAA credit rating and a yield structure at the higher end of most developed nations. It would seem that part of the recent fall in US Treasury yields is being driven by much of the same influences.

While we readily accept these factors are supporting the fall in global bond yields, we are doubtful they are the primary influence behind the fall in Australian bond yields. If indeed this was the case, then our way of thinking a scarcity premium (reflected in the margin between the sovereign yield curve and swap curve) should be observed. In fact, this is not the case. Perhaps surprisingly the spread between these has remained remarkably stable over the past couple of years, having widened significantly during the Global Financial Crisis.

Swap yields at any point in time provide the markets judgement of where it believes bank bill rates will be over the term of the swap, or more simply, the markets expectations of the future path of cash rates. If we accept that a longer term bond yield reflects the market expectations of where short term rates will be over the term of the bond plus an appropriate term premium then it is instructive to look at the extent to which these expectations have changed over recent times.

At the end of April 2014, the 10 year Government bond yield was 3.95%, the 10 year swap rate was 4.26% and the margin between the two was 31 basis points. What were these yields reflecting about the longer term expectations for cash rates?

Back then, the overnight cash rate was 2.5% which was expected to be the low point for this cycle. At this time the market was priced for the RBA to begin the next monetary tightening cycle in the first half of 2015 and to continue gradually lifting the official interest rate for much of the next decade. By mid-2018 the rate was priced to be slightly above 4% and to be slightly above 5% by the end of the decade. Interestingly these expectations averaged close to the RBA's current view of where the neutral or equilibrium cash rate currently sits.

Let's contrast this to the situation today.

The current 10 year government bond rate is around 2.4%, the 10 year swap rate 2.75% and the margin around 35 basis points. This pricing reflects an expectation that the cash rate will fall to 2% in the very near term and remain there for the next couple of years. Beyond that the RBA is expected to begin lifting the cash rate very gradually reaching around 2.75% by mid-2018 and 3.25% by the end of the decade. It is these set of expectations that have driven the 10 year swap to its current record low level of 2.75%. Another way to think of this is that the market expects the six month bank bill rate to average 2.75% over the next 10 years.

Thinking of long term yields in this way confirms that much of the decline in Australian bond yields and swap rates has far more to do with changing expectations as to how low the cash rate may fall and more importantly how far it may ultimately rise, rather than foreign demand for Australian fixed interest assets. Of course the answer to this will only be revealed in hindsight, but from our perspective, these expectations reflect an overly pessimistic view of how the Australian economy may perform over the medium to longer term.

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The Australian economy faces some significant challenges over the coming years as it strives to achieve a more diversified growth profile and reduce its reliance on the mining sector. Low interest rates (possibly moving even lower in the short term), a weaker Australian dollar, low oil prices and a substantial rise in commodity exports (most notably LNG) are likely to underwrite a steady recovery in GDP growth over the medium term. If this scenario unfolds the unemployment rate is also likely to trend lower from its current level of a little over 6%. Further improvement in the global growth outlook should also be supportive for the domestic economy.

It is in this context that we feel longer term yields have moved into very expensive territory and offer investors poor long term value and potentially substantial risk. Fixed interest returns will be much lower in the future, having been surprisingly resilient over recent years as yields have fallen. The current yield of the Australian bond market is around 2.5%. For overall returns to be better than this, yields need to keep falling and this is not our view. Further monetary easing, should it occur, would increase our confidence in the growth outlook and potentially increases the risk of owning longer dated bonds.

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