

Fixed Interest in 2020

Volatility Set to Continue

The New Zealand fixed income market felt the full effects of global economic and geo-political issues in 2019, and we believe 2020 will be no different. Interest rates remain near all-time lows with most of the big gains already made throughout 2019. However, bonds play an important role in any diversified investment portfolio and should continue to do so as we enter the later part of the current cycle.

Key Points:

- Interest rate volatility set to continue for a while yet
- An abundance of risk remains in 2020
- A diversified investment portfolio including bonds can help reduce overall portfolio risk

Volatility already in 2020

We are only midway through the first month of 2020 and already geo-political risks have emerged with the US–Iran spat sending the yield on the US 10 year -12bp lower. Given much of the fixed income market direction comes via the US, it could be an interesting 2020 if the US remains at odds with China, North Korea and now Iran. The US will also succumb to election fever (as will NZ) from around June onwards. Will President Trump get a second term? Will Trump sort out the China trade situation prior?

There are so many unanswered questions and, as always, unknowns that may make 2020 just as volatile as any other year in the fixed income market. Whilst it is certain that there are uncertainties lurking around the corner, much of it is noise and could be resolved relatively quickly, meaning good news will also impact interest rates.

What does all this mean? A sideways shuffle in fixed income seems to be a likely outcome; however, we remain cautious of any forecasts or predictions given the volatile state of the world and some of its leaders.

Why bother with bonds?

With the New Zealand equity market delivering a +30.4% return in 2019 (the best since 2000) and interest rates hitting all-time record low levels, some investors may be asking why bother with bonds at all? It is a fair question, in particular, when you consider that bond proxies (listed property stocks) gained +31.3% over 2019!

The end of the current bull market is anyone's guess but most would agree that the longer it goes on, the closer we get to some form of market correction. This is where investors must consider the risk/return characteristics of their investment portfolios. It is possible to reduce the risk within investment portfolios by adding bonds, without significantly impacting returns.

Investment View

We are entering the 11th year of a bull market with most asset classes at records highs. Just like individuals making their New Year's resolutions about getting fit or weight loss, it is also a good time to 'spring clean' your investment portfolio and make sure it is fit for purpose. By adding bonds to investment portfolios volatility can be reduced.

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What's up in 2020?

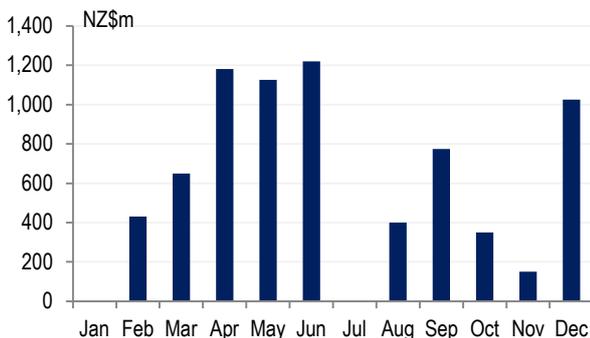
Locally there are two key themes that could impact the fixed income market. Firstly, the yet to be determined criteria for bank Capital Securities may finally see some issuance in this sector, providing much needed liquidity and higher yielding bonds. Secondly, the general election will be held in the latter part of 2020, which will bring an abundance of promises and policy to the forefront of businesses and individuals.

Banks' attitude in 2020 will be interesting

With the Bank Capital Review saga now largely behind us the local fixed income market can now hopefully look for new Capital Securities being issued at some point in the near future. However, we wouldn't be expecting a plethora of new issuance based on the completion of the new set of criteria due to be established by mid-2020. Why? The Reserve Bank of New Zealand (RBNZ) announced a seven year transitional timeline for the banks to meet the new capital requirements, giving banks plenty of time should they choose to issue new Tier one and Tier two securities. We do, however, expect some banks to issue in the second half of 2020, once the criteria is finalised post the distribution of a discussion paper in April.

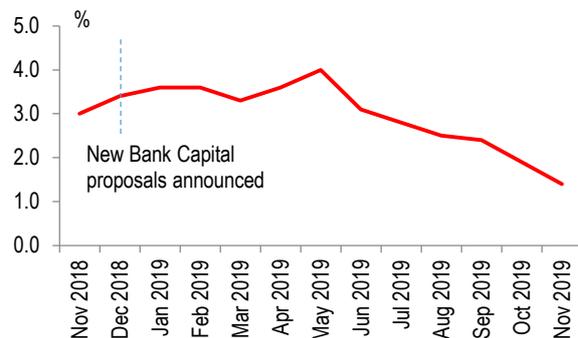
It will be interesting to see the banks, in particular the big four banks, response to the conclusion of the watered down new capital requirements. A reduction of credit to the rural sector is already well underway (see Figure 2) which was widely forecast by many as soon as the draft proposals were released in December 2018. Will the spare lending capacity be reallocated to the housing market? Or will banks look to slow credit growth and therefore reduce the additional capital required to fund its operations? Given the very healthy profits the Australian banks make in New Zealand it seems unlikely that we will see any great pullback in credit (to certain sectors).

Figure 1. 2020 corporate bond maturity profile



Source: Forsyth Barr analysis, exclu. NZGB's and Kauri's

Figure 2. Annual credit growth rate – agricultural lending



Source: Forsyth Barr analysis, RBNZ

Maturity profile

Excluding the April 2020 New Zealand Government bonds (NZ\$5.7bn) and a number of Kauri bonds, there is ~NZ\$7.3bn of fixed income that is set to mature in 2020. In an illustration of how far interest rates have fallen over the last few years, a number of the bonds maturing in 2020 have coupons above 8.0% (Mercury 8.21%, Genesis Energy 8.30%, Infratil 8.50%).

It would appear that the likely redemption of ANZ's (ANBHB NZ\$500m) and Kiwibank's (KCFHA NZ\$150m) Additional Tier One securities may come a touch too early for any possible replacements. The RBNZ discussion document around the new rules for Capital Securities does not get released until April, with rules to be implemented in response to that document (a couple of months process at least).

Infratil has already announced a rollover option for its maturing February bond (IFT090) and more than likely Fletcher Building Finance will do the same for FBI140 prior to its election date on 15 March.

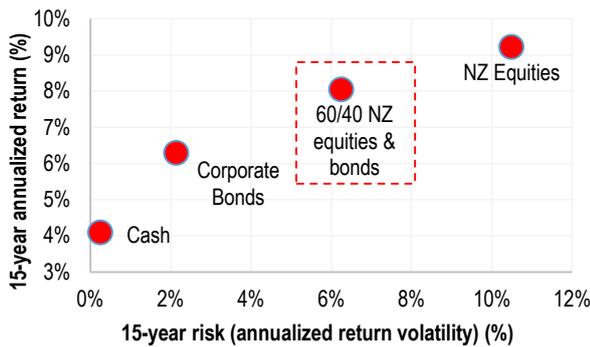
Over the last couple of years New Zealand corporates have mainly refinanced bank debt, as opposed to issuing new debt to expand and we believe that this trend is likely to continue.

Risk v Return

Finding the optimal balance between debt and equity can often be difficult, especially in the current market, where low interest rates can make bonds look unattractive and is supportive of equities, in particular New Zealand equities which can often pay healthy dividends.

Looking solely at New Zealand equities and bonds, a combination of 60% equities and 40% bonds produced an 8.0% p.a. return over a 15 year period. Whilst that is 120bp p.a. lower than having only New Zealand equities, by adding 40% of New Zealand A rated corporate bonds, the annualised volatility of the portfolio reduces by 420bp.

Figure 3. Reduce risk by adding bonds



Source: Forsyth Barr analysis, Bloomberg

Figure 4. Asset class returns

Investment	Return (p.a.)	Risk
Cash	4.1%	0.3%
Corporate Bonds	6.3%	2.1%
NZ Equities	9.2%	10.5%
60/40 NZ equities & bonds	8.0%	6.3%

Source: Forsyth Barr analysis, Bloomberg

We believe a fixed income portfolio should contain a good mix of securities across the credit curve, with a bias to investment grade securities. Sourcing liquidity is not always easy in the New Zealand fixed income market, however, we continue to recommend it where possible.

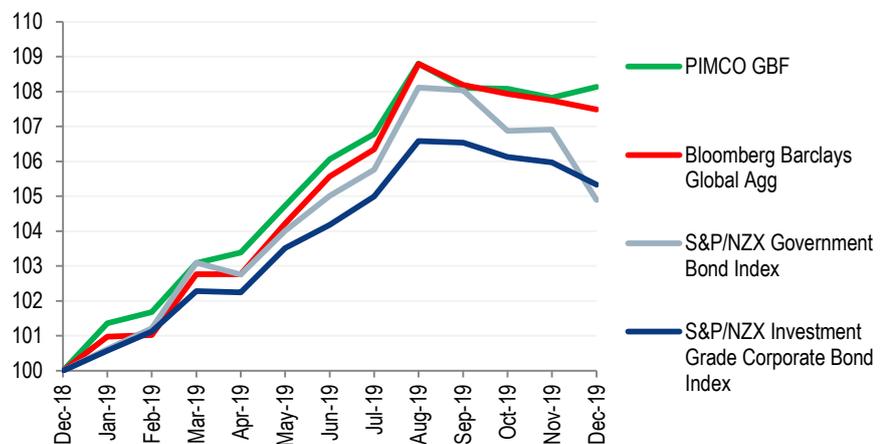
Diversification and liquidity are two key features of any fixed income portfolio.

Local v Global

In 2019 we introduced global bonds to our portfolios in order to diversify away from solely New Zealand bonds. It is also highly likely that many portfolios would be exposed to both the debt and equity of the same New Zealand company. By adding a large global bond fund such as PIMCO (NZD Hedged) we also improved liquidity of fixed income portfolios.

As interest rates began to rise at the beginning of October last year, the ability to react and utilise multiple fixed income securities across multiple currencies has led to an outperformance by PIMCO over local bonds.

Figure 5. Local bonds versus global bonds



Source: Forsyth Barr analysis, rebased to 100, PIMCO GIS Global bond fund NZD hedged before fees & taxes.

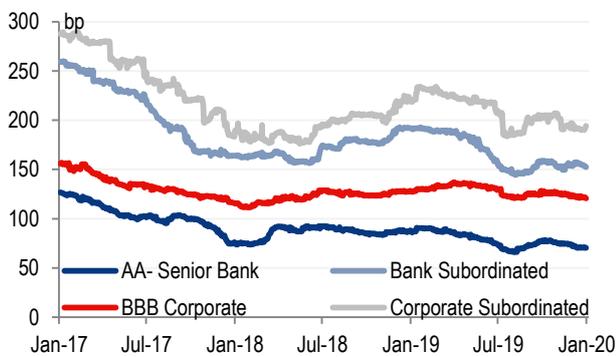
Credit Spreads

The bank credit curve is the most unambiguous curve and therefore it provides an excellent benchmark for credit. In early 2019, CBA kicked off proceedings with a five year senior bond priced at 113bp, fast forward 12 months and ANZ has just raised A\$500m at 76bp over swap. New Zealand bank debt is priced slightly wider (10–15bp) than its parent, due to being subsidiaries, and corporate debt is then priced relative to the bank curve.

Notwithstanding the unique nature of the New Zealand fixed income market, nearly every issue in 2019 was issued at the low end of the indicative range as demand outstripped supply. This continues on from 2018 illustrating the impact of a lack of issuance and the absence of large bank capital securities.

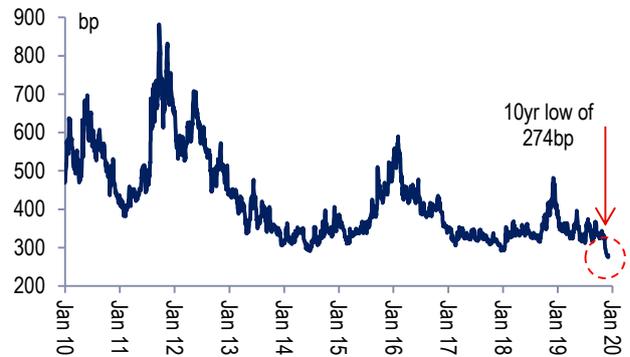
If the bank capital security market gets back underway, then the increased issuance may add some competitive pressure to credit spreads in favour of fixed income investors for a change.

Figure 6. NZ credit spreads – not a lot of action in 2019



Source: Forsyth Barr analysis, Bloomberg

Figure 7. US High Yield 5yr credit spreads



Source: Forsyth Barr analysis, Bloomberg, Markit CDX North America High Yield Index

Interest rates not credit spreads providing the boost

The headline yields on corporate bonds fell significantly in 2019 as underlying interest rates fell. The performance of the bond market was predominately down to falling interest rates not contracting credit spreads. As Figure 7 highlights this may be changing, with high yielding credit spreads reaching their tightest point in over decade. Clearly the credit market in the US is not seeing any economic issues on the horizon.

Credit spreads in New Zealand remain largely flat, particularly for the longer dated bonds issued in 2019. With the majority of New Zealand corporates being able to fund their operations via a number of local and offshore markets, New Zealand fixed income investors are once again playing follow the leader. Australia has been a favoured destination for a number of New Zealand corporates who have been able to issue 10 year bonds at attractive levels. Issuers such as Spark, Fonterra, Auckland International Airport and Heartland have all utilised the growing Australian debt market.

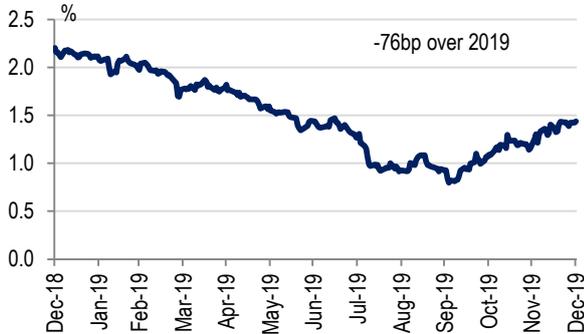
Figure 8. Credit spreads remained pretty flat in 2019

Type	Code	Issue date	Maturity	Coupon	Current yield	Current margin	Issue margin
Bank (Senior)	ABB080	19/08/2019	19/08/2024	1.83%	2.04%	0.76%	0.85%
Corporate (Senior)	VCT090	27/05/2019	27/05/2025	3.45%	2.60%	1.27%	1.65%
Property (Senior)	ARG010	27/03/2019	27/03/2026	3.45%	3.15%	1.76%	1.75%
Local Authority	LGF110	20/04/2019	20/04/2029	1.50%	2.16%	0.57%	0.48%
Corporate (Sub)	NZR010	14/12/2018	1/03/2024	5.10%	4.00%	2.74%	2.62%

Source: Forsyth Barr analysis, Thomson Reuters, current margin over relevant swap rate, NZR010 first election date used

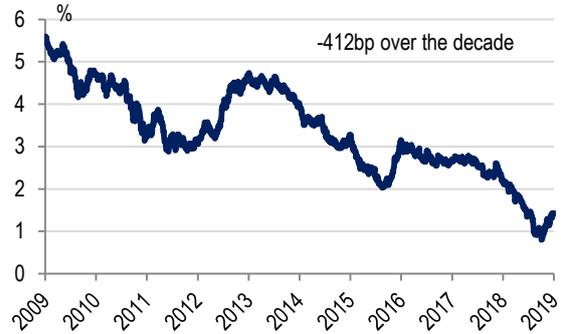
Over the Year / Decade

Figure 9. NZ five year swap rate (2019)



Source: Forsyth Barr analysis, Thomson Reuters

Figure 10. NZ five year swap rate (last 10 years)



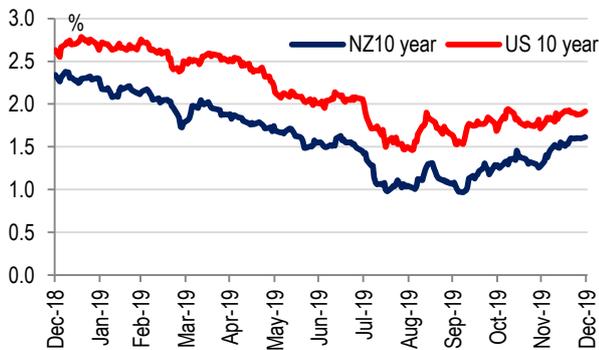
Source: Forsyth Barr analysis, Thomson Reuters

Figure 11. New Zealand swap rates

2019	1yr	5yr	10yr	10yr-2yr
Current	1.16%	1.30%	1.64%	0.47%
Low	0.85%	0.80%	1.09%	0.22%
High	1.94%	2.18%	2.64%	0.73%
Last 10 years	1yr	5yr	10yr	10yr-2yr
Low	0.85%	0.80%	1.09%	0.04%
High	3.95%	5.60%	6.15%	2.17%

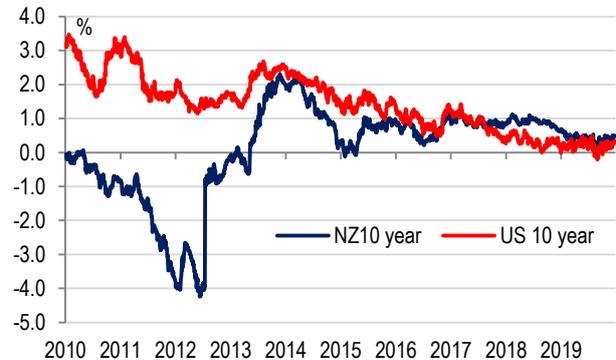
Source: Forsyth Barr analysis, Thomson Reuters

Figure 12. NZ & US 10yr benchmark interest rates



Source: Forsyth Barr analysis, Thomson Reuters, 10yr NZGB & US 10yr Treasury note

Figure 13. Yield curve steepness (10yr less 2yr)



Source: Forsyth Barr analysis, Thomson Reuters

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