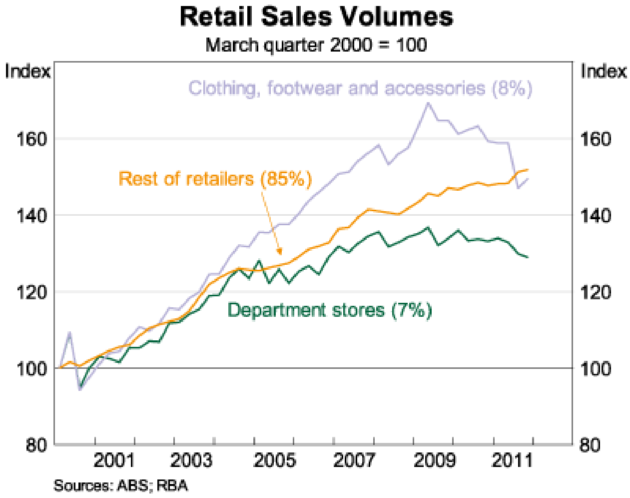
State Government Debt

12th April 2012

State Governments are being challenged by falling revenues and rising liabilities. Weakness in retail sales and changing consumer behaviour is reducing GST revenue (internet sales do not attract the GST). Is this a paradigm shift that could lead to a permanent reduction in GST receipts?

In addition, the depressed housing market is affecting stamp duty revenue. Auction clearance rates have fallen substantially, reducing the number of transactions that duty can be charged on, in addition the transactions that are proceeding are at lower prices. Housing turnover has declined from 1 in 12 at its recent peak, to approximately 1 in 25. This reduction in revenue is increasing budget deficits.



The high credit rating of State Governments has typically resulted in their respective bonds trading at tight spreads to Commonwealth Government Securities ("CGS"). However, during periods of market distress, semi-government bond spreads will widen, as investors seek to hold more of the safest and most liquid securities – namely CGS. This is particularly apparent with offshore investors, who are not always familiar with the vertical fiscal integration in Australia and how State Governments are funded. This often occurs during periods of market dislocation.

The spread between semi-government securities and CGS widened to over 120 basis points during the GFC, up from around 25 basis points pre the crisis. Recent market uncertainty has caused spreads to rise again and test old spread highs. Queensland and South Australia, due to their deteriorating budget position, rating actions and forecasted liability increases, have posted new highs of around 160 basis points to CGS.

Structural debt issues out of Europe and the US are likely to lead to another round of volatility. In this environment, flows will continue to favour CGS, leading to a potential widening of state government spreads.

Such an occurrence would potentially provide a compelling long opportunity, providing a specific spread target is difficult given the confluence of variables.

Ultimately as an investor you need to make a call on whether there is a real probability of default (and whether state governments are bail out remote in a worst case). Working on the assumption that this is not the case the trade may well present value at some point, the decision then becomes that of timing.

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