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Aussie bonds hit all-time highs

by Christopher Joye

A momentous occasion occurred at 12.15pm on Thursday: for the first time in history, a AAA-rated Australian Commonwealth government bond was bought and sold for a fixed 10-year yield – or interest rate – of less than 2 per cent (1.9955 per cent to be precise).

Shorter-dated three-year Aussie government bonds also traded at new record lows of sub 1.5 per cent, which is more than a standard 0.25 percentage point Reserve Bank of Australia rate cut below the current 1.75 per cent cash rate.

Despite above-trend economic growth that has run at a 3.6 per cent annualised rate over the six months to March – and Sydney and Melbourne house prices that have jumped 13.4 per cent and 15.2 per cent over the last year – the $1.4 trillion local bond market is pricing in just one rate hike during the next decade.

To put this new nadir in context, the average interest rate that our 10-year government bonds have had to pay since 2000 has been 4.94 per cent, or almost 2.5 times more than contemporary yields.

"Another major financial market milestone just evaporated as the relentless search for safe yields – and the increasing prevalence of negative 10-year government bond yields – fuels the bid for Australia's highly-rated bonds that pay attractive risk-adjusted returns in a global context," says Charlie Jamieson, a top-performing sovereign fixed-income fund manager. (Brexit, which we will return to later, has also helped intensify this bid.)

His partner at the eponymous Jamieson Coote Bonds, Angus Coote, adds that breaking through the 2 per cent yield floor "is massive because it demonstrates we can go much lower".

"Negative interest rates were a mind-melt for bond investors yet they have become the norm in places like Germany and Japan, which makes our AAA-rated government bonds with circa 2 per cent yields stand out like a bull's balls," the ever-blunt Coote continues.

Risk-free rate

This is a big deal for every asset class because the risk-free rate used to price future cashflows – or discount them back to the present as a representation of the minimum opportunity cost of capital – appears to be shrinking.

In theory, lower through-the-cycle risk-free rates mean higher valuations for all asset classes (all things being equal), including corporate bonds, listed equities, private equity, commercial property and housing.

When Commonwealth Bank issues, say, a five-year senior (subordinated) floating-rate note paying 1.1 per cent (2.6 per cent) above the 2 per cent bank bill swap rate, or 3.1 per cent (4.6 per cent) in total, that spread is clearly worth a lot more today in relative terms than when the cash rate was, say, 4 per cent in 2012 or 7 per cent in 2008,

"Credit spreads are the extra risk premium investors demand over cash returns, and as the riskless benchmark compresses arguably credit spreads should contract as well to maintain relativities,"Jamieson contends.

JCB's flagship fund, which is attracting interest from financial planners and other sophisticated investors, has returned 5.89 per cent net of fees over the year to May 31, which has smoked its Aussie government bond benchmark (up a skinnier 4.5 per cent).

Of course, all things are not equal right now.

Yields deliberately crushed

Government bond prices are not surging higher of their own accord: the Bank of Japan, European Central Bank, Bank of England and US Federal Reserve have spent north of $10 trillion buying risk-free (and in the case of the ECB and BOJ, which are buying corporate bonds and equities, risky) assets to deliberately crush yields to maintain their arbitrarily determined growth targets.

It's a new form of financial protectionism: shield bad businesses and leveraged households from the dispassionate decisions of free markets. After all, central bankers know better.

While fixed income has performed exceptionally well – and smashed the much more volatile equities market by a country mile since before the global financial crisis – it must be psychologically challenging for smart chief investment officers (CIOs) to allocate capital to an asset class paying 1.5-2.0 per cent yields, or negative "real" returns after inflation over 5-10 years.

While noting that further declines in sovereign yields could boost the total returns delivered by fixed-rate bonds, Andrew Papageorgiou from Realm Investment House, which oversees $190 million, argues that "very low expected returns coupled with substantial drawdown risks if inflation ever reignites must be weighing on asset-allocators' minds right now".

Multi-decade malaise

In crises, high-grade government bonds have proven to be an excellent hedge against losses in equities. But if excessive monetary and fiscal stimulus drives inflation expectations higher and/or growth – heaven forbid – normalises (wait, aren't we already above-trend?), the biggest-ever bull market in government bonds could catch a multi-decade malaise.

"There is absolutely a place for this form of catastrophe insurance in portfolios, but savers ultimately need positive real incomes and so CIOs are rationally thinking about how to safely secure superior yields," Papageorgiou says.

One of Realm's responses has been to take an overweight position in the banks' listed additional tier one (AT1) capital hybrids, the much-maligned perpetual preferred equity instruments that offer spreads of about 5 per cent above the 2 per cent bank bill swap rate (or total returns of 7 per cent). This column led the hybrid critique since 2011, but has recently warmed to them after a sharp valuation adjustment and altered supply-demand dynamics.

"We are 4 percentage points above our 15 per cent strategic portfolio weight to AT1 hybrids," Papageorgiou says.

For years the exclusive domain of naïve retail punters, the blow-out in AT1 spreads from post-GFC lows of 280 basis points to about 500 basis points today has convinced institutions like Unisuper to return to the market. And fears about a tsunami of supply have diminished after a landmark Australian Taxation Office ruling that allowed ANZ to issue the first AT1 deal overseas in 10 years, which allegedly garnered US$18 billion in (artificially inflated) bids.

Brexit or Bremain?

What should investors make of "Brexit" or "Bremain"? Polling has been heavily biased by reliance on land-line telephones, which has skewed samples. Who has one these days?

A record $60 million has been gambled on the outcome of the referendum, and betting markets on Thursday were putting the odds of the UK leaving the EU at 42 per cent.

Assuming you trust the weight of money and not pollsters pushing products, Brexit is another one of the long list of exogenous shocks that have over the last 12 months presented attractive buying opportunities for those of a contrarian disposition.

This was true of the second Greek-EU crisis in June 2015 (the first was in 2012), the Chinese equity market collapses in August 2015 and January 2016 and the European bank-cum-Aussie sub-prime crisis in February 2016, which was spruiked by hedge funds talking up their shorts.

Save for the dark and sluggish domestic cash (not derivatives) fixed-income market, most asset classes – including listed equities, foreign exchange, and interest rates and commodity derivatives – are informationally efficient.

By the time the Bremain results are declared, the valuation mispricings may therefore have disappeared.

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