
Floating Over the Fixed Abyss

STATE STREET GLOBAL ADVISORS

As an Australian investor, holding long-duration, fixed rate bonds during the first quarter of 2022 would have felt like staring into a deep abyss as inflationary pressures continued to build and interest rate markets sold-off across the curve. Floating rate note securities fared better but did not escape the carnage.



Simon Mullumby, CFA
Head of Australian Cash and
Bonds

For the majority of debt instruments, the first quarter of 2022 was a very tough start to the calendar year as widening credit spreads hit the asset class hard. Senior unsecured floating rate notes did not bear the brunt of the weakness, purely because of their short interest rate duration, but were not immune to weaker global credit markets.

In attempting to dissect the quarter into palatable bite size snippets of what drove the market, it's worth discussing the three main drivers - building inflationary pressures, the Ukraine invasion and bank issuance.

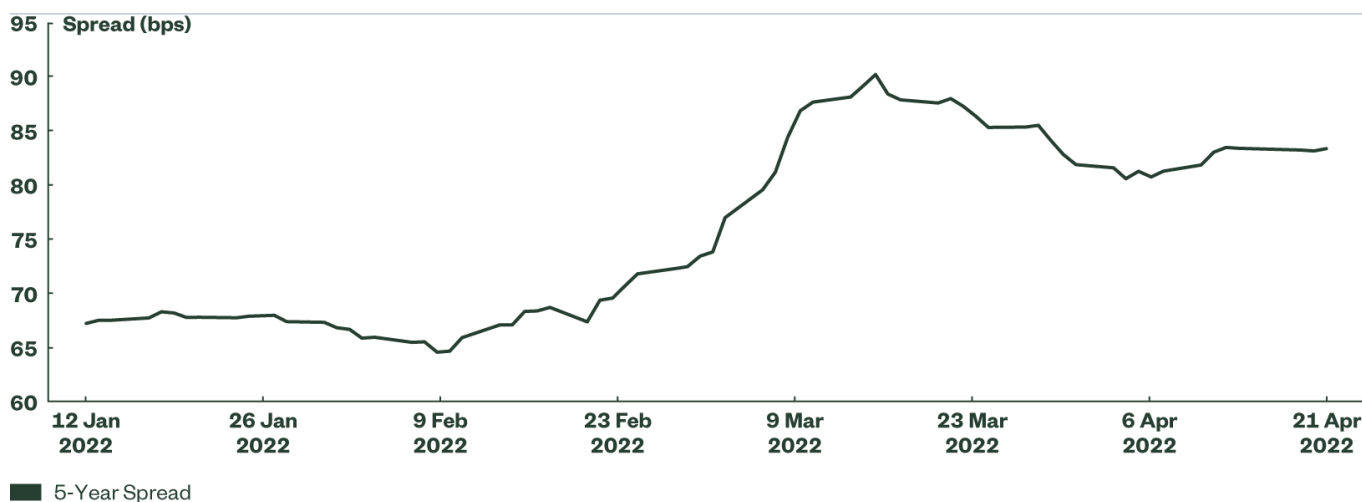
Inflationary pressures both domestically and offshore repriced the yield curve of most developed markets during Q1. It is becoming increasingly apparent with offshore central banks tightening monetary policy and the much anticipated 'soon to tighten' Reserve Bank of Australia, that after two years plus of very stimulatory monetary policy, both via traditional and non-traditional methods, the global economy has made it out of the COVID pandemic. As global central banks withdraw stimulus, coupled with ongoing supply chain issues, we believe that interest rates are going to move higher. In some countries much higher. Globally, there were many investment grade bond indices that recorded their worst first quarter of performance since the 1980's. It was a brutal move higher in yields, and spread products via fixed credit markets, were dragged along for the bumpy ride.

Secondly, was the Russian invasion of Ukraine. For a brief period in late February, the rates market had a risk-off tone as bonds were bid aggressively. This was however short lived. The realisation came very quickly that Russia is a huge supplier of both oil and gas to the global economy. As sanctions were implemented, countries (especially in Europe) procured replacement markets for Russian goods and services, and were willing to pay higher prices that added to already surging global inflationary pressures. Again, bonds were sold aggressively with some fixed income markets seeing eye watering losses particularly in the long end of the curve as yields blasted off from historic lows driven by the pandemic. Credit and spreads were again dragged along for the repricing however short-duration exposures fared much better than, for example, 10-, 20- or 30-year fixed-rate bonds.

Finally, and some would argue most importantly, was sporadic offshore domestic bank issuance during Q1. Whenever a domestic bank issues notes offshore, the issue is immediately swapped back /converted to what the market can digest as a spread-to-swap. All senior unsecured bank floating rate notes in AUD are priced and traded at a spread to 3-month Bank Bill Swap Rate (BBSW). Whenever a bank issues in USD or EUR for example, the issuing bank will disseminate to the market what this off-shore primary note equates to as a spread to 3-month BBSW. This is where the majority of the quarters underperformance in floating rate notes stemmed from. Australian and Canadian banks are well known for being on the front foot in term of issuing in volatile times. Q1 2022 was volatile as markets embraced the notion that inflation was not transitory but entrenched. Markets were very volatile and under stress for sustained periods due to the conflict in Eastern Europe and this ensured that some of the Australian major four banks were mandated to print sizeable offshore debt issuance, and they paid up for the primary

market support. Some prime examples of major four bank issuance during the quarter comes to mind. In late January, a major did a 5-year issue at +0.70% to 3-month BBSW for 5 years. In March, a major bank did a USD 5-year issue that swapped back to AUD 3-month BBSW +1.05%. Over subsequent days all major 5-year floating rate notes were repriced at 0.90%+ to 3-month BBSW ensuring that shorter issues were also dragged much wider than days earlier (see Figure 1 for an example).

Figure 1: Volatility of 5-Year Spread on CBA 5YR Floating Rate Note 27/01/22



Source: State Street Global Advisors, Bloomberg Finance L.P., as at 21 April 2022.

In addition to domestic bank weakness across the curve, some international banks headquartered in Europe, saw the Australian money market move their spreads even wider. Not only because of the aforementioned local issuance price widening, but also due to a few fearful market participants who sold all their European bank holdings, which in most instances, accounted for a de minimis Russian exposure.

The Bottom Line

The rate environment has shifted rapidly. Whilst Floating Rate Note securities fared better than many other fixed income segments, they did not escape the market carnage. Recent spread widening has created some short term performance challenges for investors but it presents an opportunity to create or increase a position in high quality bank credit to complement traditional cash in a rising rate environment to help produce income.

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