Fixed-Rate Pricing – The Reassessment Continues

The third quarter of 2022 saw continued market volatility across all asset classes. Against this backdrop, we assess how the floating-rate segment performed and why fixed-rate repricing should persist into the new year.

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Market volatility is often driven by multiple factors. Yet, in the third quarter of 2022, it was clear that the catalyst behind the turmoil was inflation – and when prices in developed economies start to rise faster and more aggressively outside of a central banks comfort band, investors expect central banks to react with tighter monetary policy. Which they did, as global policymakers recognised that inflation was anything but transitory.

A Notable Imbalance Between Supply and Demand

However, another factor was in play. Outside of COVID-initiated supply-chain issues and fossil-fuel challenges driven by the Russia-Ukraine conflict, the withdrawal of pandemic-related stimulus has revealed a significant imbalance between supply and demand in most goods that needs to be addressed. And until an equilibrium of sorts is achieved, higher cash rates, tighter monetary policy, and higher yields will be commonplace.

Floating-Rate AUD Bank Spreads Remain Steady

In market terms, floating-rate senior-unsecured Australian-dollar (AUD) bank spreads managed to hold their ground over the quarter. Even as fixed Australian government bond yields sold off sharply across the curve, credit spreads in senior-unsecured bank notes with bullet maturities traded in a predominantly liquid market. Indeed, it was sometimes hard to source investment-grade AUD-issued bank paper. That's not to say there wasn't intra-month volatility, and on several occasions, we saw equity markets post eye-watering losses.

Forced Selling and Gilt-Market Pressure

On days with blanket selling across most asset classes, credit spreads were dragged wider in sympathy with the risk-off style positioning. Added to this were periods in the latter stages of the quarter when offshore-domiciled liability-driven investment (LDI) funds were forced sellers of their sovereign and credit positions to fund margin calls. This came as the Gilt curve was under enormous selling pressure on elevated inflationary concerns. In this environment domestic investment-grade senior-unsecured credit again mirrored offshore credit in late September by moving wider.

Fixed-Rate Repricing and Weaker Yields

So, as we enter the final quarter of 2022, it appears that in the wake of the sell-off to wides not seen for years, domestic senior-unsecured bank spreads have found an equilibrium of sorts and further substantial widening will face resistance.

We believe that fixed-rate repricing should continue and this may be challenging for long duration bonds. Moreover, yields are expected to weaken further as the market embraces a period of central-bank-assisted healthy inflation. Given where domestic bank spreads have remained amid the market volatility, shortening the interest-rate duration through an allocation to floating rate notes may be a palatable option for some.

Figure 1: Markit iTraxx Australia IG Spread (bps) (Last Twelve Months)

Source: Bloomberg Finance L.P., as of 13 October 2022. Past performance is not a reliable indicator of future performance.

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