



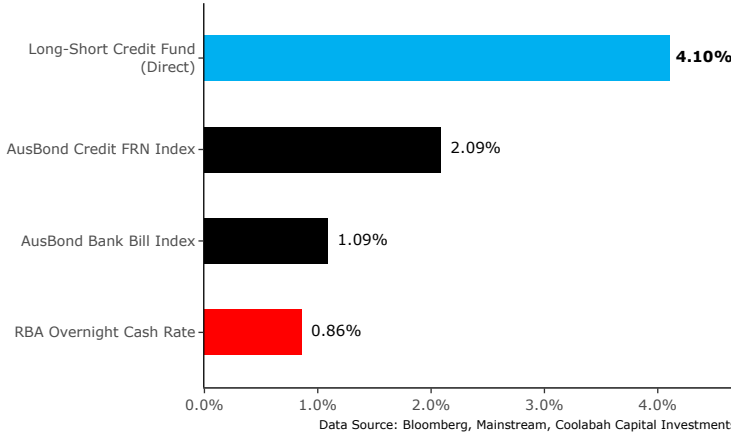
August 2021

Objective: An absolute return fixed-income strategy focused on exploiting long and short mispricings in credit markets that targets high-yield like returns above the Reserve Bank of Australia (RBA) cash rate plus 4% to 6% p.a. over rolling 3 year periods with volatility of less than 5% p.a. after Management Fees, Administration Fees and Performance Fees.

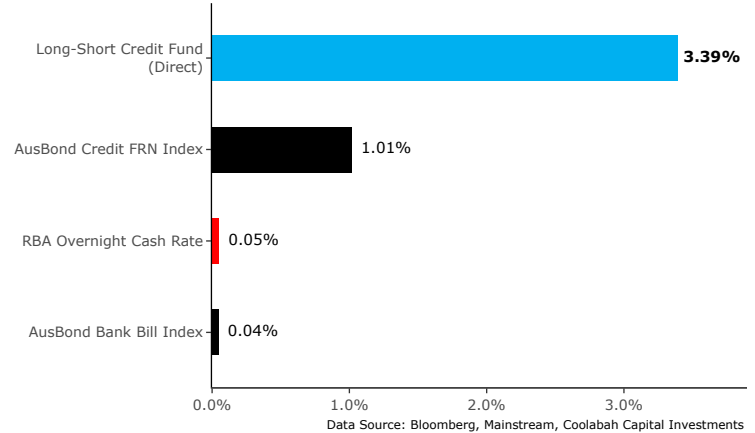
Strategy: We add value via active asset-selection using a range of valuation models with the aim of delivering superior risk-adjusted returns, or alpha, to traditional hedge funds. We primarily invest in senior and subordinated debt securities, hybrids and derivatives issued by Australian entities domestically, although we can invest in these securities when they are issued overseas, or by overseas entities (into Australia or offshore). The Fund can use gearing and targets holding the majority of its portfolio in investment-grade securities. It is managed by Coolabah Capital Investments.

Period Ending	Gross Return (Direct)	Net Return (Direct) [†]	RBA Cash Rate	Gross Excess Return [‡]	Net Excess Return (Direct) ^{†‡}
2021-08-31					
1 month	-1.55%	-1.62%	0.00%	-1.55%	-1.62%
3 months	-2.98%	-2.88%	0.01%	-2.98%	-2.89%
6 months	-1.62%	-1.99%	0.02%	-1.63%	-2.00%
1 year	5.68%	3.39%	0.05%	5.63%	3.34%
2 years pa	5.60%	3.44%	0.27%	5.33%	3.17%
3 years pa	6.33%	4.13%	0.64%	5.68%	3.49%
Inception pa Aug. 2017	6.20%	4.10%	0.86%	5.34%	3.25%

Long Short Credit Fund Returns (Net) vs Benchmark (pa)
Annualised Returns Since Inception in August 2017 to 31 August 2021



Long Short Credit Fund Returns (Net) vs Benchmark
12 Month Return to August 2021

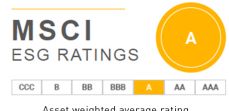


[†] Net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement. [‡] The Excess Return columns represent the gross and net return above the RBA cash rate.

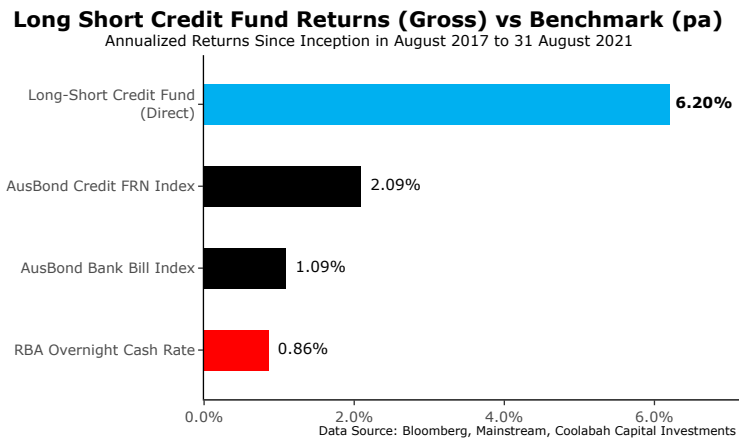
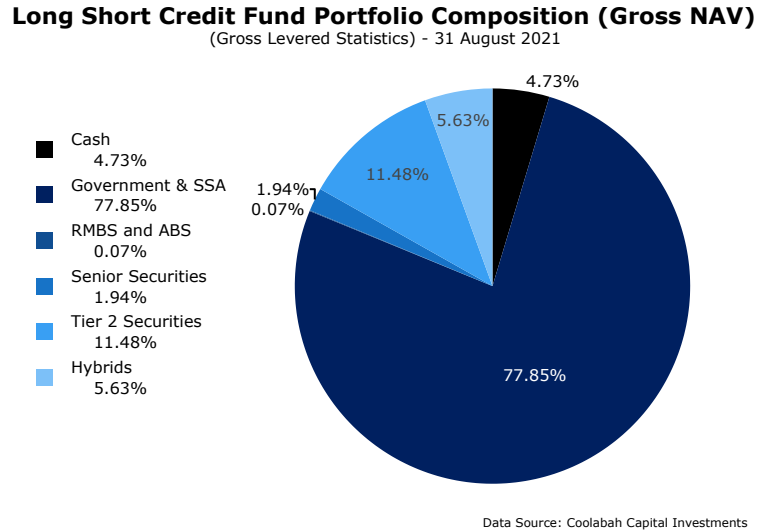
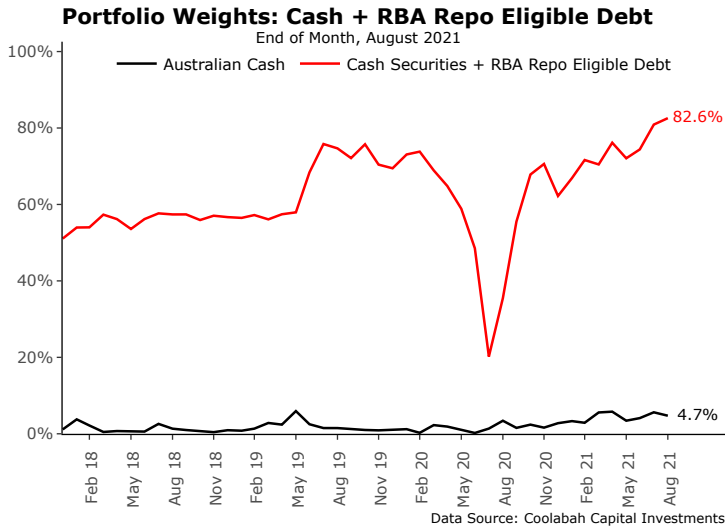
Disclaimer: Past performance does not assure future returns. Returns are shown net of all Management and Performance fees unless otherwise stated. All investments carry risks, including that the value of investments may vary, future returns may differ from past returns, and that your capital is not guaranteed. To understand Fund's risks better, please refer to the Product Disclosure Statement available at Coolabah Capital Investments' [website](#).

Net Monthly Returns > RBA Overnight Cash Rate	77%	Permitted Gearing	Yes
Gross Portfolio Weight to Cash Securities	4.7%	1 Year Av. Gross Portfolio Weight to Cash	3.6%
Gross Portfolio Weight to Bonds	97.0%	Gross Portfolio Weight to AT1 Hybrids	5.6%
Av. Portfolio Credit Rating	AA	Gross Cash Securities + RBA Repo-Eligible Debt	82.6%
Portfolio MSCI ESG Rating	A	Gross Portfolio Weight to ABS/RMBS	0.1%
No. Cash Securities	4	Net Credit Spread Duration Ex Govt	3.00 years
No. Notes and Bonds	84	Net Annual Volatility (since incep.)	3.11% pa
Av. Interest Rate (Gross Running Yield)	4.18%	Gross/Net Sharpe Ratio (since incep.)	1.66x/1.04x
Modified Interest Rate Duration	0.15 years	Awards: FE Alpha Manager 2019: Christopher Joye; Ratings: Lonsec available to advisers; Recommended (Atchison); 'Superior More Complex' (Foresight Analytics)	

Signatory of:



Asset weighted average rating



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The since inception gross (net) return of **6.20% pa gross (4.10% pa net)** is the total annual return earned by the fund since Aug. 2017, including interest income and movements in the price of the bond portfolio after all fund fees (assuming net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement). The net return quoted applies to the Smarter Money Long-Short Credit Fund - Direct Investor Class, with quarterly distributions reinvested. Each investor's return will vary depending upon their own investment date and any top-ups and withdrawals they make. The **annualised volatility estimate of 3.11% pa** is based on the standard deviation of net daily returns since inception, which are then annualised, attributable to the Smarter Money Long-Short Credit Fund - Direct Investor Class.

Portfolio Managers	Christopher Joye, Ashley Kabel, Dr Stephen Parker, Dr Nick Campregher (Coolabah Capital Investments)		
APIR Code	SLT2562AU	Fund Inception	31-Aug-17
ISIN	AU60SLT25623	Distributions	Quarterly
Morningstar Ticker	41597	Unit Pricing	Daily (earnings accrue daily)
Asset-Class	Alternatives/Hedge Funds	Min. Investment	\$1,000
Target Return	Net 4.0%-6.0% pa over RBA cash rate	Withdrawals	Daily Requests (funds normally in 3 days)
Investment Manager	Coolabah Capital Investments (Retail)	Buy/Sell Spread	0.00%/0.05%
Responsible Entity	Equity Trustees	Mgt. & Admin Fee	1.00% pa
Custodian	Mainstream Fund Services	Perf. Fee	20.5% of returns over RBA cash rate + 1.00% pa

Portfolio commentary: The zero-duration and daily liquidity Long-Short Credit Fund (LSCF) ended August with a weighted-average credit rating of AA, a portfolio weighted average MSCI ESG rating of A, and a running yield of 4.18%. Over the previous 12 months, LSCF returned 5.68% gross (3.39% net), outperforming the benchmark RBA Overnight Cash Rate (0.05%) by 5.63% gross (3.34% net).

Since the inception of LSCF 4.0 years ago in August 2017, it has returned 6.20% pa gross (4.10% pa net), outperforming the benchmark RBA Overnight Cash Rate (0.86% pa) by 5.34% pa (3.25% pa net). LSCF's since inception Sharpe Ratio, which measures risk-adjusted returns, has been 1.66x (1.04x) gross (net). While LSCF's return volatility since inception has been low at around 3.11% pa (measured using daily returns), as a daily liquidity product with assets that are marked-to-market using executable prices, volatility does exist. This contrasts with illiquid credit (eg, loans and high yield bonds) wherein assets that have very high risk can appear to have remarkably low volatility, which is, in fact, just a mirage explained by the inability to properly value these assets using executable prices.

Strategy commentary: The month of August capped off a quarter where the yields on our portfolios lifted sharply, cheapening current valuations across our core holdings, including government bonds and bank-issued Tier 2 bonds and hybrids. As is always the case when we find cheaper assets, we have substantially increased our portfolio exposures to the relevant sectors, opening the door to a rebound in returns as spreads normalise (or mean-revert).

This note will provide a detailed breakdown of the spread moves, expected catalysts for mean-reversion, prospective opportunities, and how we have adjusted the portfolios to capitalise on these mispricings.

While almost all our bond yields increased in August, the demonstrably best-value, or cheapest, positions we hold are also our most liquid and safest: namely State government bonds (also known as "semis"). The interest rate spread paid by these AA and AAA rated bonds above the yield on Commonwealth government bonds has jumped by a historically unusual 30 basis points (bps), on par with the near-record 30-40bps increase in semi spreads observed during the original pandemic shock in March 2020.

At circa 45bps over 10-year Commonwealth government bond yields, NSW's 10-year bonds are trading on spreads that are 50% higher than the ~30bps average that prevailed between 2014 and 2018, in line with the highest levels touched in 2018, and around the average levels observed just before the COVID-19 shock.

In a world where most asset-classes are very expensive, this is one sector that offers a compelling opportunity, which we have been eager to exploit.

We have more than doubled our portfolio exposure to State government bonds since we took profits on about one-quarter of this position at the recent lows in their interest rate spreads in May 2021. Across the market there is now an emerging consensus that semis are cheap, with the likes of PIMCO [recently highlighting that this is a core area of focus](#).

In recognition of these prospects, Coolabah's investment team, directors and shareholders have been boosting their allocations to the portfolios by more than \$50 million in recent months.

12mth Scenario Analysis Total Returns				Scenario Analysis Returns		
Av. Rating	Running Yield	RBA Cash Rate	If spreads normalise 50% of recent widening	If spreads normalise 75% of recent widening	If spreads normalise 100% of recent widening	
Long Short Credit Fund	AA	4.2%	0.10%	6.0%	7.9%	9.9%
Active Comp. Bond Strategy (FIXD)	AA	2.5%	0.10%	3.6%	4.6%	5.5%
Smarter Money Higher Income Fund	AA-	1.2%	0.10%	1.4%	1.8%	2.1%
Smarter Money Fund	AA-	1.0%	0.10%	1.2%	1.6%	1.9%

Assumes: Semi spreads retrace some percentage of recent widening and hybrid spreads reach CCT's targets
Past performance does not assure future returns. All investments carry risks, including that the value of investments may vary, future returns may differ from past returns, and that your capital is not guaranteed. Refer to investment disclaimer at start of presentation. Please read the Product Disclosure Statement which can be found at www.coolabahcapital.com

Source: Bloomberg, Coolabah Capital Investments

Strategy commentary cont'd: The table above presents some scenarios regarding possible returns if spreads across key positions start mean-reverting in line with our expectations. (Please note the forward-looking disclaimer at the end of this email and that these are only scenarios: they are not indicative of future returns.)

The current weighted-average interest rates and average credit rating on Coolabah's retail portfolios are outlined below:

- Smarter Money Fund: 1.0% pa yield (AA- rating)
- Smarter Money Higher Income Fund: 1.2% pa yield (AA- rating)
- Active Composite Bond Strategy (Chi-X: FIXD): 2.5% pa yield (AA rating)
- Long Short Credit Fund: 4.2% pa yield (AA rating)
- Active Australian Hybrids Fund (ASX: HBRD): 3.4% (BBB- rating)

It is important to note that our portfolios are expected to produce negative total returns in typically 2 to 3 months each year when credit spreads increase, lifting the portfolio yield while compressing current valuations. This has historically supported future returns. Specifically, the Smarter Money Fund normally records 1-2 negative months a year. The Smarter Money Higher Income Fund typically registers 2 negative months a year. The higher-returning Active Composite Bond Strategy and Long Short Credit Fund are meant to record negative months 2-3 times a year. And HBRD has averaged 2-3 negative months per year.

Given the reduction in interest rates towards zero since 2011, one should, in fact, anticipate a higher number of negative months each year simply because the portfolio yield is smaller, which means there is less of an income buffer to offset increases in spreads.

In the sections that follow we offer detailed analysis on our key positions and the expectations for these holdings.

1. 5-year major bank hybrids spreads increased by 5-6 basis points (bps) in August as banks front-run new ASIC marketing rules

ASIC is introducing new marketing regulations that will make it much harder for banks to sell hybrids to retail investors from 5 October 2021, which has triggered a sudden spike of supply in August.

These new regulations known as "design and distribution obligations" (DDO) require hybrid issuers to take responsibility for the types of investors they sell the products to.

Most banks are therefore switching to sell hybrids only to wholesale, not retail, investors. This will likely mean smaller ASX hybrid deals and more securities issued into the unlisted institutional market, which should be a positive for listed hybrids as supply will be less than it has been in the past.

In August the market had to unusually absorb no less than three bank hybrid deals from:

- **Macquarie:** the \$655m new MBLPD hybrid paying 290bps over the quarterly bank bill swap rate with an expected repayment date of 7 years (this was a new money deal that did not replace an existing hybrid that was maturing)
- **Westpac:** the \$1.45bn new WBCPK hybrid paying 290bps over the quarterly bank bill swap rate with an expected repayment date of 8 years (this was a hybrid that was replacing Westpac's \$1.7 billion WBPCG hybrid that will be repaid on 20 December 2021)
- **Suncorp:** the \$375m new SUNPI hybrid paying 290bps over the quarterly bank bill swap rate with an expected repayment date of 6.75 years (while this was a new money hybrid, it effectively replaces the \$375m million SUNPF hybrid that will be repaid on 17 June 2022)

The net result of this new supply pushed 5-year major bank hybrid spreads up from 248bps to ~253-254bps (ie, plus 5bps to 6bps) above the bank bill swap rate, giving us higher future yields traded-off against reduced current valuations.

Strategy commentary cont'd: We had expected this front-running of supply because of the looming introduction of ASIC’s marketing rules in addition to the fact that we don’t believe CBA will issue a new hybrid to replace its \$1.4 billion CBAPE security, which will be repaid in October.

We had recently reduced our exposure to the hybrid market in anticipation of this supply, although we are bullish on the sector for the remainder of 2021 because you will have two very large hybrid maturities (ie, the \$1.4bn CBAPE in October and the \$1.7bn WBCPG—ex any rolls from this hybrid into the new WBCPK—in December furnishing investors with a lot of cash looking for a home).

While we made small investments in all three deals in August, we have been focussed on buying cheaper hybrids in the secondary market after previously reducing our exposures in expectation of wider spreads.

The major bank hybrid market is far and away the cheapest part of the bank capital structure right now, and materially cheaper than major bank subordinated bonds and, even more so, major bank senior bonds.

Between 2013 and 2020, major bank 5-year hybrid spreads traded at about 4x the spread on 5-year senior bonds. This ratio is currently over 6x, implying hybrids offer much better value than senior bonds. In terms of outright spreads, 5-year major bank hybrids traded in the 235bps area in 2014 – they remain well wide of that today at 254bps.

Coolabah is forecasting that S&P will upgrade the credit ratings on major bank hybrids from BBB- to BBB, which should put further downward pressure on spreads. We are also projecting that 5-year major bank hybrid spreads will converge towards 235bps by the end of the year.

The chart below shows the ratio of 5-year major bank hybrid spreads currently compared to 5-year major bank senior bond spreads. As you can see, the ratio sits at over 6x when historically it has averaged around 4x.



Source: Bloomberg, Coolabah Capital Investments

2. Major bank Tier 2 bonds: spreads about 5bps wider in August

In the bank Tier 2 bond market, we had been materially derisking our exposures in anticipation of new supply and August delivered with the first local major bank Tier 2 bond issue since January 2020 when Westpac issued.

CBA issued a large \$1.5 billion, Tier 2 issue (we bought over \$150 million) at 132bps over BBSW, which was cheap, and it has since tightened slightly to around 127bps on the bid side.

We sold about \$250m of Tier 2 before this deal, and have since started buying again. The CBA deal pushed spreads wider from about 126bps to 132bps above BBSW, detracting from current performance but boosting future yields.

On an historical basis, the major banks’ 5-year Tier 2 bonds have normally traded at 1.5x to 2.5x their senior bond spreads (see chart below). We currently put this ratio at over 3x, implying that Tier 2 is quite cheap.

Strategy commentary cont'd: While we are now buying in secondary again, we are not expecting Tier 2 spreads to compress sharply in the near-term, primarily because we project that the major banks' senior bond spreads will normalise from 40bps to around 60-70bps over the bank bill swap rate over the next 12mths.

This will be driven by (1) repayments of the money banks borrowed under the RBA's \$188bn Term Funding Facility, which must be returned to the RBA within 3 years, and (2) the additional debt funding banks will require when APRA announces what we forecast will be a material reduction in the banking system's Committed Liquidity Facility from \$139bn currently to close to zero over the next 2 years. This will necessitate banks issuing debt to buy extra government bonds (see more on this below).

We are, however, forecasting that S&P will upgrade the major banks' Tier 2 bond ratings from BBB+ to A-, which could reduce spreads materially given how important the A band rating bucket is for many investors.

The chart below shows the ratio of 5-year major bank Tier 2 spreads currently compared to 5-year major bank senior bond spreads. As you can see, the ratio sits at over 3x when historically it has averaged around 2x.



Source: Bloomberg, Coolabah Capital Investments

3. AAA and AA rated State government bond spreads: About 7bps wider in August (30bps wider since May)

Since late May 2021 we have seen one of the largest increases in State government bond spreads in history, almost on par with the absolute increase in spreads observed during the March 2020 shock, which presents unique investment opportunities.

The interest rate spread on 10-year NSW and Victorian government bonds above the Commonwealth government bond yield has jumped by about 30bps, from 15bps in May to around 40-45bps today (similar to the 30-40bps move observed in March 2020).

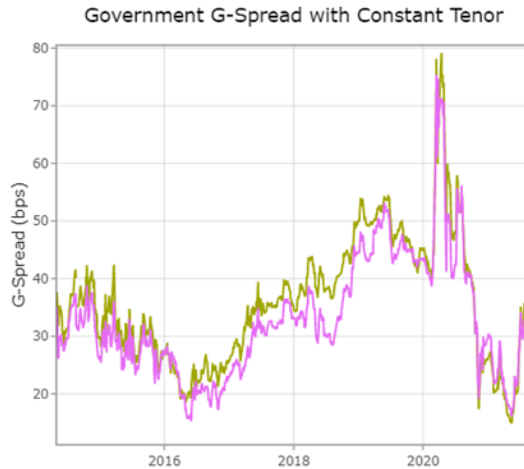
At circa 45bps over 10 year Commonwealth government bond yields, NSW's 10-year government bonds are trading on spreads that are 50% higher than the ~30bps average that prevailed between 2014 and 2018, in line with the highest levels touched during 2018, and are around the average levels observed just before the COVID-19 shock in 2019.

And yet the RBA is buying about \$1bn of State government bonds each week, and is expected to continue buying these bonds until mid-to-late 2022 during which time it will purchase another \$30bn of semis on top of the \$40bn it has already acquired. This should reduce net semi supply in FY22 from \$85bn to \$55bn before considering the impact of the \$139bn CLF going to zero, which will force banks to buy these assets as well.

The chart below shows 10-year NSW (brown line) and Victorian (purple line) government bond spreads above the yield paid on 10-year Commonwealth government bonds. The very recent increase is hard to discern because it is almost a straight-line!

This unusual move is, we believe, an attractive buying opportunity and we have more than doubled our exposure to State government bonds since the tights in spreads in May.

Strategy commentary cont'd:



Source: Bloomberg, Coolabah Capital Investments

To recap on our original thinking in May 2021, we had sold almost one-third of our State government bonds but retained a smaller exposure because we expected robust performance in the months ahead as a result of two key drivers:

- **We thought the State and Federal budgets would be smaller than expected, necessitating less debt issuance.** This proved correct in May and June with all Federal and State budget deficits for FY21 coming in a lot lower than governments (or the market) had originally anticipated. In NSW’s case, the cash deficit in FY21 was \$12bn less than the State forecast. In turn, we expected the States and the Feds to issue materially less debt than they had guided. This again proved out with all States (except NSW) and the Feds materially downgrading FY22 debt issuance expectations.
- **We thought the RBA would announce a QE3 program of \$100bn plus, which they effectively did. The surprise was the “taper” of their bond purchases starting in September (announced in July), which the market did not expect.** Notwithstanding the NSW and VIC lockdowns, the RBA should reconfirm its QE3 taper in September, although it will likely taper on a much slower schedule than it had previously planned. This is consistent with the signalling from the RBA’s preferred media commentators. **The most important thing is the total size of QE3, which we estimate will be between \$140bn and \$150bn (given the slower taper), which is much larger than the market’s original QE3 estimates of circa \$50bn to \$100bn and generally positive for State government bond spreads.** You can read our analysis [on the size of the taper here](#).

So what pushed State government bond spreads wider in June in light of all of this otherwise constructive news?

The initial shock was NSW announcing proposed debt issuance of \$35.5bn in FY22, which was 50% more than what NSW issued in FY21, and almost double what the market expected for FY22 despite the much smaller-than-projected NSW budget deficit in FY21 (it was \$12bn less than NSW forecast). This supply shock pushed State government bond spreads 15-20bps wider over the next month or so.

While it took us some time to figure out why NSW wanted to issue so much debt, we were the first participants to identify that NSW was planning on indirectly raising as much as \$20bn to \$47bn of extra public debt to allow NSW’s investment arm, TCorp, to invest in equities and other financial markets via TCorp-managed funds (see [our detailed analysis of this proposal here](#)).

The biggest fund in question is the NSW Generation Fund’s Debt Retirement Fund, which holds \$15bn of cash for debt repayment purposes. And this month the cash in the Debt Retirement Fund will increase to to \$28bn when the second-half of WestConnex is sold for approximately \$13bn.

The problem was this plan conflicted with the Debt Retirement Fund’s original intent and its [very precise 2018 legislation](#), which clearly required this “rainy-day” budget buffer to be expressly used to:

Strategy commentary cont'd:

- reduce the debt of the State,
- maintain NSW's AAA credit rating (which was lost in December 2020 because of a surge in debt issuance),
- reduce the cost of government debt, and
- to reduce fiscal risks.

The idea of taking on \$20bn to \$47bn of extra public debt to allow TCorp to invest in stocks and other markets would have:

- increased the debt of the State to record levels,
- contributed to further undermining NSW's AA+ credit rating (when the Debt Retirement Fund's express purpose is to help maintain the AAA rating), and
- immediately increased the cost of NSW government debt to a higher level than all the other States, which was a historical first.

In fact, NSW taxpayers are now in theory going to have to pay more than \$350 million a year in extra interest on their outstanding debt as a result of the jump in the spreads on NSW government bonds since this yet-to-be-implemented scheme was unearthed.

Importantly, after two months of very vigorous private and public ESG activism (see [the AFR's coverage here](#)), NSW's Treasurer has now reaffirmed his commitment to:

1. not raising any new debt for these funds, and
2. using the \$28bn in the Debt Retirement Fund to help reduce current and future public debt, as the Treasurer had originally envisioned.

The COVID-19 lockdown has provided the perfect rationale for a much-needed pivot away from the plan that triggered the spike in NSW spreads. It should also be noted that the NSW Treasurer presciently created the Debt Retirement Fund in 2018 using NSW's budget surpluses and privatisations precisely so he could draw-down on these reserves to help alleviate the fiscal pressures that would emerge in a future crisis. (He probably never imagined he would face a 1-in-100 year pandemic.)

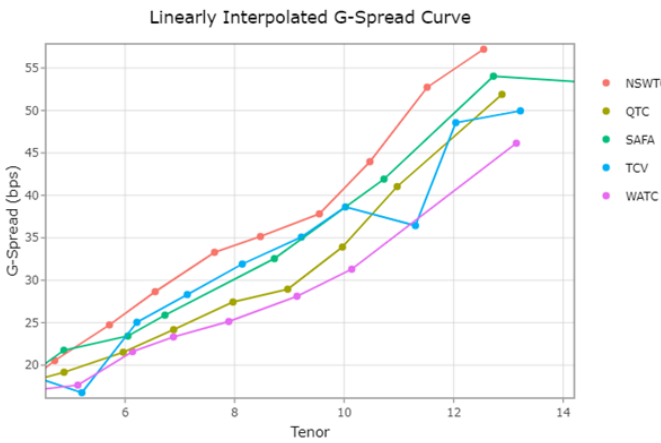
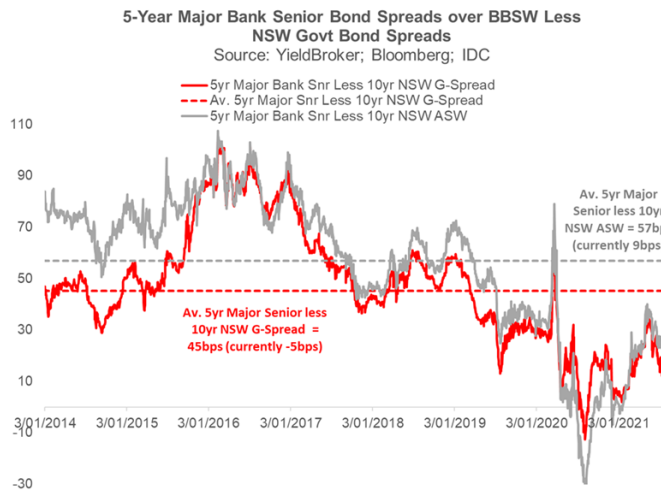
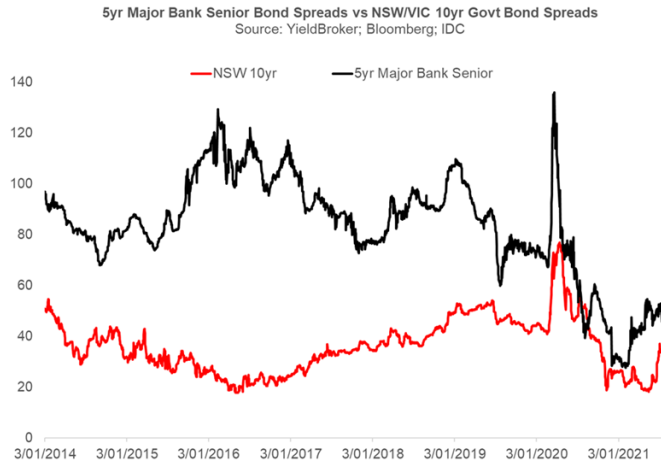
While the specific details of the revised NSW proposal for the Debt Retirement Fund have not yet been released (and are expected in September once the second half of WestConnex is sold), we believe that they will contribute to very materially reducing NSW's funding needs and its spreads.

A second unexpected surprise in July was the Delta-induced NSW and Victorian lockdowns, which have raised concerns about State government debt issuance. Combined with the uncertainty swirling around NSW's original debt funding shock, investors have been anxious that the lockdowns might materially add to debt supply. This has contributed to another circa 10bps of spread widening, bringing the cumulative total to around 30bps for 10-year State government bonds.

This means that for one of the few times in history, the spreads on 10-year NSW and Victorian government bonds are now clearly above the spreads on the major banks' senior bonds (see below). This is important because, as one might expect, lower rated, less liquid and much riskier major bank senior bonds normally trade on materially higher spreads than those on State government bonds. And many investors switch between the two assets.

We also have the bizarre situation where NSW's cost of capital is now higher than all of the other major States, as illustrated in the next chart below. This means that the benefit of the RBA buying \$40bn (to date) of State government bonds as part of its QE programs, which in 2021 pushed 10-year State government bond spreads to as low as 15bps over Commonwealth bonds, has completely disappeared, with spreads pushing back out to historically elevated levels well-above those observed before the RBA started QE.

Strategy commentary cont'd:



Source: Bloomberg, Coolabah Capital Investments

This begs the question: as we look ahead, what factors will help normalise semi spreads? There will be several key drivers, some of which we have touched on above:

1. Debt issuance will be a lot less than the market expects

The market is concerned that the \$85bn of semi issuance in FY22 might blow-out to \$100bn because of the NSW and VIC lockdowns. We expect total debt issuance to actually be reduced to \$80bn to \$85bn in FY22 because of a number of factors:

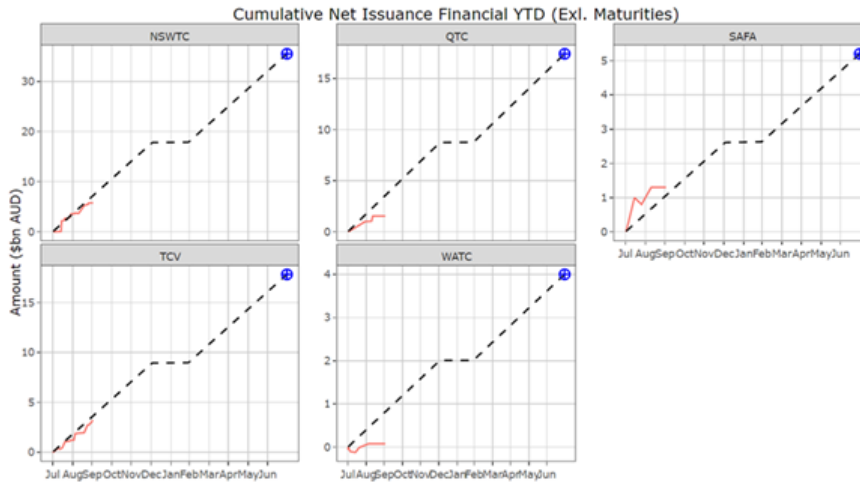
Strategy commentary cont'd:

- **\$28bn of cash ready for debt clearance:** We think that even with the NSW lockdowns, the \$28bn in the Debt Retirement Fund will allow NSW to reduce its official \$35.5bn funding task for FY22. This \$35.5bn included over \$7bn of investments in TCorp funds, which will be cancelled. It also included \$20bn of capex that is likely going to be shifted into future years.
- **Lockdown costs 50% of expectations:** We know from the live NSW data on their lockdown spending, which they disclose daily online, that they are only burning \$58m per day on all their COVID programs, or \$1.75bn per month – which is less than 50% of the \$4bn per month cost they originally provisioned and which has been used in the market. Note this is based on them paying out all applications for support rather than the actual money they have spent. The bottom-line is that JobSaver payments have been a fraction of expectations (business support is similar to expectations).
- **NSW lockdown to end in October:** So starting in mid July, and assuming that COVID support is wound-back by the start of November (given NSW will hit 70% and 80% double-jabbed persons in October) that implies the total cost is \$4bn to \$6bn. Yes, there may be a revenue hit to stamp duty, payroll tax, and land tax, but GST looks fine (see more below) and they will a lot of that leakage back in Q3 and Q4 given the substantial fiscal stimulus (much of which is picked up by the Commonwealth government) that will power spending.
- **The \$35.5bn assumed massive spending that will be cancelled/deferred:** With the \$7bn to \$8bn of savings from not diverting revenues to investment funds in FY22 (plus another \$13bn of cancelled commitments in future years), combined with the \$13bn of cash coming in from WestConnex this month plus the \$15bn of cash already in the Debt Retirement Fund and big reductions in the \$20bn of proposed capex, there is nothing stopping NSW actually cutting its FY22 funding task from \$35.5bn to somewhere between \$20bn and \$30bn.
- **GST revenues remain strong:** Nationally, GST revenues have remained unchanged, which is the single biggest source of State government tax revenue (about one-fifth), because States and Territories like QLD, WA, SA, TAS and NT are fully open. This signals that the overall Australian economy is robust despite the lockdowns in NSW and VIC, as exemplified by the stronger than expected June quarter GDP print of 0.7%. (Obviously the September quarter will be weak with a contraction of 2.5% to 4.0%, which should be recovered in the following two quarters.)
- **Other states will revise down requirements:** We expect that the smaller States and Territories, including WA, SA, TAS, QLD and NT will continue to revise-down their funding needs as domestic activity maintains its healthy pace

All of this points to a lower-than-assumed funding task in FY22 of \$80bn to \$85bn. And if there was any doubt about NSW might do with the Debt Retirement Fund, [John Kehoe has reported in the AFR](#) that:

NSW Treasury Secretary Michael Pratt revealed on Friday that the “unique” unforeseen budget pressures caused by COVID-19 meant he would submit options to the Treasurer about adjusting the NSW Generations (Debt Retirement) Fund strategy, including using it for “debt clearance”. Proceeds from the coming sale of 49 per cent of the WestConnex toll road – estimated at \$13 billion – would be immediately paid into the fund as required by legislation, but some revenue could then be diverted to reduce the state’s rising debt. “The government has choices,” Mr Pratt said, in response to questions from Labor shadow treasurer Daniel Mookhey at a parliamentary committee meeting. “It will be time to reflect on what is the optimal size of the fund, should government actually retire some debt earlier or not. These are things I’ll be looking at,” Mr Pratt said. NSW Treasury secretary Michael Pratt is preparing advice for the Treasurer. “I would say the Treasurer obviously has ongoing options about those issues and also about whether future money could be used directly for debt clearance which is the purpose of the fund.”

Strategy commentary cont'd: Perhaps most revealingly, if we look at the actual \$ value of semis bonds issued by the States in FY22 to date, you can see that almost all the States are running well behind their proposed issuance programs. This implies that they are comfortable doing less than what they have announced despite the first few months of the year normally being a busy period for supply. Our system screenshot below shows semis issuance vs what they had proposed following their budgets.



Source: Bloomberg, Coolabah Capital Investments

2. Net semis supply will be much lower again because of a smaller CLF and RBA QE

With the RBA buying somewhere between \$30bn and \$40bn of semis in FY22, actual net supply will be around \$45bn, which is miles below both the official \$85bn estimate and market concerns of \$100bn.

One then has to account for changes to APRA and the RBA’s Committed Liquidity Facility. Following the GFC and the ensuing runs on banks in Australia and overseas (eg, Northern Rock), regulators came up with the sensible idea that banks should hold more emergency liquidity.

One important metric is the Liquidity Coverage Ratio (LCR) that represents the percentage of high-quality liquid assets (HQLA) a bank holds relative to the expected cash outflows they would suffer in a 30-day, GFC-style shock. In Australia, banks target LCRs above 12%.

Around the world regulators decided the safest and most liquid asset a bank could keep was government bonds. In Australia, however, there simply was not enough public debt outstanding to provide the HQLA the banking system needed without undermining the liquidity of the market.

So the Reserve Bank of Australia’s governor-in-waiting, Guy Debelle, came up with an excellent back-up plan called the Committed Liquidity Facility (CLF). To the extent that banks could not find enough government bonds (or cash on deposit at the RBA, which is another form of HQLA), APRA and the RBA would allow them to use “alternative liquid assets” (ALA) as a substitute. Under the CLF, banks can shift these ALAs to the RBA in a crisis, which will then lend to the banks holding the ALAs as collateral.

Now this is where it gets thorny. First, we allowed our banks to use their own internal home loans as ALAs, which is not permitted in other jurisdictions. This is an immensely profitable form of substitute HQLA for the banks to employ. Rather than having to raise extra money and going out and buying low-yielding government bonds, the banks are using loans they have already funded. And banks earn returns on equity north of 20% to 30% on home loans, making the CLF fee of 0.2% annually appear trivial.

Unsurprisingly, about 80% of the CLF asset pool is now made up of internal loans. For taxpayers and central banks, these are the worst imaginable liquid assets to accept from a bank in a crisis. In a perfect world, the RBA would be given safe and liquid government bonds, which it could then lend against.

Strategy commentary cont'd: Instead, the CLF forces it to accept the failing banks' own loans. This is known as a "wrong-way" risk and is exacerbated by the fact these internal loans have no liquidity. If the bank does fail, it is going to be hard for the RBA to sell these assets for anything remotely resembling their officially accepted value (even after a haircut).

Another asset that is allowed in Australia's CLF, which is not permitted overseas, is senior unsecured bonds issued by banks themselves. This has led to the bizarre situation whereby the biggest buyers of Aussie bank bonds are the banks themselves.

NAB recently completed an enormous \$2.75 billion senior bond issue, 67% of which was bought by its peers. It is not uncommon for the major banks to bid for more than \$300 million to \$500 million of another bank's bond just for their CLF books.

Even more remarkably, banks can also buy non-bank issued residential mortgage-backed securities (RMBS), sold by lenders who are not even regulated by APRA, in their CLF portfolios.

APRA and the RBA have always been clear that the CLF would only exist for as long as Australia had insufficient government bonds to hold without the CLF. Technically, the banks are meant to do everything possible to buy government bonds to meet their LCR requirements before asking to be able to use it.

The good news is that with over \$1.5 trillion of government bonds and cash available at the RBA, there is now no need for the CLF. This has been **clearly demonstrated by analysis published by the former global head of interest rate strategy at UBS, Matthew Johnson**. He concludes that "APRA and the RBA could eliminate the CLF starting in 2022 – if they wanted to".

APRA has been diligent in repeatedly writing to the banks over the last year and warning them that given the growth in government debt the CLF will go to zero "in the foreseeable future".

But the only bank that is listening is ANZ. ANZ's outstanding treasurer, Adrian Went, says that APRA has made its position clear – the CLF is going to zero – and that there is more than enough government bonds and central bank cash for banks like ANZ to hold.

So ANZ has prudently downsized its CLF by \$37 billion since 2019, which means that it now makes up just 4.4% of ANZ's HQLA. As a result, ANZ now holds over \$210 billion of government bonds and cash at the RBA, 47% bigger than the next closest bank, NAB, which only holds \$143 billion.

Westpac appears the worst offender, relying on the CLF for 21.4% of its HQLA, above NAB (17.4%), CBA (17.1%), and ANZ (4.4%). Westpac holds three times as much CLF in dollar terms as ANZ despite the latter retaining almost twice as much HQLA. No prizes for guessing which banks invested huge sums in the recent NAB bond issue, and which bank invested none because it is focused on getting its CLF to zero.

Where's the problem for taxpayers? Well because banks are using their internal loans in the CLF (and other banks' bonds), they are boosting their profits and lowering their funding costs while increasing the cost of taxpayer debt above where it would otherwise be.

Before the CLF came into being, the four major banks used to pay interest rates on their senior bonds that were 0.70 to 0.80 of a percentage point higher than what, the Victorian and South Australian governments pay when raising money.

Today the difference is below zero partly because the CLF is used to reduce the banks' funding costs, and to feather profits, to the detriment of taxpayers.

The banks will squeal that getting rid of the CLF would require them to issue more wholesale funding to buy government bonds to replace their internal loans. They will complain this will be too expensive. **Yet we've modelled exactly how much debt** the majors would have to issue over the next three years while also repaying the \$137 billion they borrowed from the RBA at the crazy-cheap rate of just 0.1% annually under the Term Funding Facility.

Between 2010 and 2020, the majors issued about \$141 billion of debt annually with peaks of \$190 billion in 2010 and \$171 billion in 2016. Getting rid of the CLF in two years and repaying the money owed to the RBA would only require them to issue \$128 billion this year, \$167 billion next year, and \$191 billion in the final year.

Strategy commentary cont'd: And the cost of their debt today is the cheapest it has been since 2007, and in high demand globally. There's never been a better time to remove what one senior banker describes as a "subsidy".

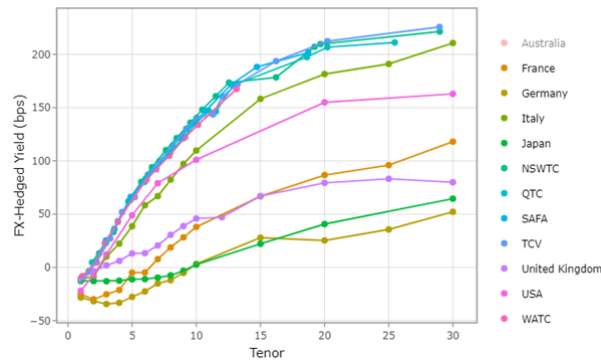
The bottom-line is that if APRA and the RBA require the CLF to go to zero over the next two years, the banks will have to replace the \$139bn CLF with \$139bn of HQLA, and specifically government bonds. This will likely drive very substantial buying of semis, which are the highest yielding government bond.

3. Swap spreads and 10 year government bond yields should also help

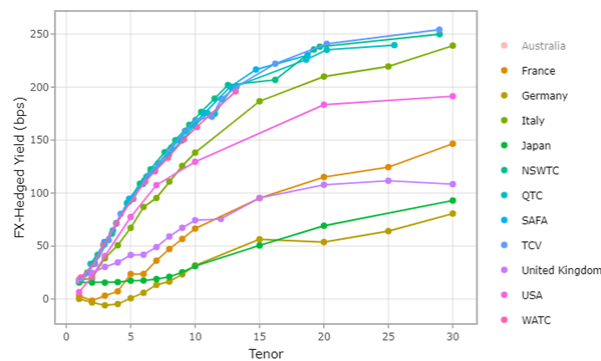
There have been two other headwinds to semis demand of late. First, the Australian 10 year government bond yield has recently dipped to 9bps below US 10 year government bonds, making Aussie bonds less attractive to foreign investors (given US yields are higher).

But with the RBA likely to be one of the first central banks to taper in September, and Aussie economic growth likely to be exceptionally strong in 2022, Aussie 10 year government bonds should start rising again.

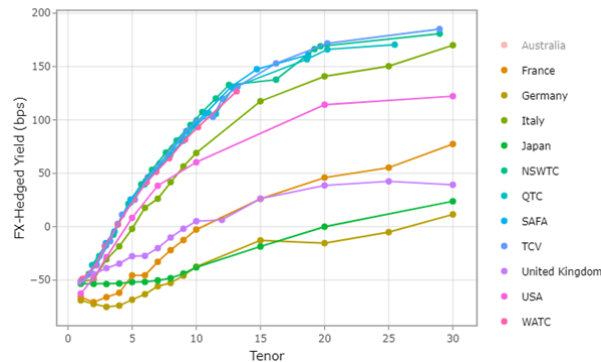
Japanese Perspective: Yield of Semis and Global Government Bonds



US Perspective: Yield of Semis and Global Government Bonds



European Perspective: Yield of Semis and Global Government Bonds



Source: Bloomberg, Coolabah Capital Investments

Strategy commentary cont'd: And with semis paying about 40-45bps above 10 year Commonwealth government bonds, they remain the highest yielding AAA and AA rated government bonds on the planet hedged into USD or EUR or JPY. The three charts below show semi hedged yields vs US, UK, Japanese, Italian, French and German bonds, hedged into USD, EUR or JPY. Semis always win. In all currencies, they pay much higher yields than even BBB rated Italian government bonds, let alone similarly rated US, British, German or Japanese government bonds...

Finally, there has been a headwind with asset swap spreads. This is complex, but when banks, which own over 50% of semis, buy these bonds as HQLA, they normally asset swap the fixed-rate bond to a floating-rate above BBSW.

The problem has been that 3-year, 5-year and 10-year asset swap rates above Commonwealth government bond yields have been increasing sharply in recent months. This has been driven by a big drop-off in Commonwealth government bond issuance from up to \$3bn to \$5bn a week in 2020 down to around \$1.5bn a week more recently.

At the same time, the RBA has been consistently buying \$4bn a week of Commonwealth government bonds. The big increase in the negative net supply of Commonwealth government bonds has pushed their yields down further on a relative basis, and has the consequence of increasing asset swap spreads above Commonwealth government bond yields.

This in turn reduces the spread that semis pay above asset swap spreads for a bank that is buying semis, making them less attractive. The other half of semi buyers, like ourselves, buy them either in outright terms, with no hedging, on a spread to Commonwealth government bonds by hedging using futures, which is what we do.

This means we get the benefit of the very wide semi spreads whereas banks have not profited as much from the recent widening because asset swap spreads have also been climbing (semis do now look much more attractive on an asset swap basis than they did in May).

The key point, however, is that as (1) the RBA tapers QE, and reduces its buying of Commonwealth government bonds, and (2) Commonwealth government bond issuance actually increases a bit to help pay for the lockdowns, asset swap spreads are likely to normalise.

There may also be some regulatory changes afoot that would reduce the amount of capital banks have to hold against their asset swaps, which would materially increase the returns they can earn from holding semis.



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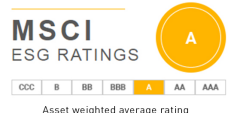
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