## 8.3. Investment and Loan Borrowings Report held as at 31 August 2022

**AUTHOR:** Christian Menday, Manager Financial Services

**ENDORSED BY:** Margaret Palmer, Director Corporate Services

**ATTACHMENTS:**
1. Investment Held Report as at 31 August 2022 [**8.3.1** - 20 pages]

**PURPOSE:**

The report provides details of the performance of Council's investment portfolio and borrowing limits for the period ending 31 August 2022.

**EXECUTIVE SUMMARY:**

**Investment Portfolio:**

The Investment Portfolio (excluding cash balances) held for the period ending 31 August 2022 had a market value of $143,897,233. The annualised returns were 1.33%. This return exceeded the Australian Bond Bank Bill performance benchmark by 0.96%.

Cash deposits at call were $17,977,772 with $16,091,410 of these held in interest bearing at call and notice accounts. $1,886,362 cash is held in Council's interest-bearing transaction account with the Commonwealth Bank to meet day-to-day operational needs. This balance included rates instalments that settled after close of business on 31 August.

The investment portfolio is managed to ensure liquidity to meet operational requirements and to fund outflows on major projects. Cashflow is monitored and assessed on an on-going basis.

The actual year to date returns for cash and investments to 31 August 2022 were $334,700 compared to a year-to-date budget of $217,700.

The Reserve Bank of Australia (RBA) Board continues to increase the official cash rate to control high inflation. At its August meeting the official rate was increased by 50 basis point to 1.85%. The RBA indicated that it expects the official cash rate to reach 2.5% by the end of the year.

Recent increases in the official cash rate are flowing though to term deposit rates bringing the prospect of improving returns for new investments. The best available returns are actively sought when surplus funds are invested.

**Borrowings:**

**Loan Facility for Council Projects**

Council entered into a fixed interest loan of $9.5 million with quarterly interest and principal payments on 31 July 2018. The principal outstanding as at 31 August 2022 is $6,147,428.

The projects funded are outlined in the body of the report.

**North Sydney Olympic Pool Redevelopment**

In January 2022 Council established a $31 million TCorp loan facility to partially fund the redevelopment of North Sydney Olympic Pool. Drawdown on the facility was processed on 28 April 2022. The drawdown rate is 4.24%. The funds will be restricted and then released as required to fund project cash outflows.

**FINANCIAL IMPLICATIONS:**

Council's total investment portfolio performance for the financial year to date is 0.96% above the benchmark (1.33% against 0.37%). The actual year to date returns for cash and investments to 31 August 2022 were $334,700 compared to a year-to-date budget of $217,700.

Investment returns will continue to be monitored and reported.

**RECOMMENDATION:**
**1. THAT** the report on Investments and Loan Borrowings held on 31 August 2022 be received.

## LINK TO COMMUNITY STRATEGIC PLAN

The relationship with the Community Strategic Plan is as follows:

5. Our Civic Leadership
5.1 Council leads the strategic direction of North Sydney
5.2 Council is well governed, and customer focused

## BACKGROUND

The Responsible Accounting Officer must provide Council with a monthly report detailing all funds:

a. Invested under Section 625 of the Local Government Act 1993. This report must include certification that the investments have been made in accordance with the Act and the Regulations made thereunder, the revised Investment Order issued by the Minister for Local Government and Council's Financial Investment Policy.

b. Borrowed under Section 624 of the Local Government Act. This report must comply with the borrowings Order issued by the Minister for Local Government and Council's Debt Management Policy.

## CONSULTATION REQUIREMENTS

Community engagement is not required.

## DETAIL

### Investment Portfolio

The following table provides details of the performance of Council's investment portfolio (excluding cash deposits) against the benchmark for the month of August 2022 and annualised for the year-to-date 31 August 2022 (including investments which have matured prior to 31 August 2022).

| | **August 2022** | **Annualised YTD as at 31 August 2022** |
|---|---|---|
| **Actual Return** | 0.17% | 1.33% |
| **Benchmark** | 0.15% | 0.37% |
| **Variance** | 0.02% | 0.96% |

The portfolio performance is increasingly driven by more recent term deposits which are attracting higher interest rates.

| Asset Type | Market Value as at 31 August 2022 | Portfolio Breakdown as at 31 August 2022 |
|---|---|---|
| Term Deposits | $130,250,000 | 80.45% |
| Cash | $17,977,772 | 11.11% |
| Fixed Bonds | $9,000,000 | 5.56% |
| FRTD | $2,000,000 | 1.64% |
| Floating Rate Notes (FRNs) | $2,647,233 | 1.24% |
| | **$161,875,005** | **100.00%** |

Council's average duration of term deposits which comprise 80.45% of the investment portfolio was approximately 459 days as at 31 August 2022.

Investment returns continue to exceed the indicative benchmark (Ausbond Bank Bill Index). All funds have been invested in accordance with the Act and the Regulations made thereunder and with Council's Financial Investment Policy. Council's investment portfolio complies with the revised Investment Order issued by the Minister for Local Government, which places restrictions on the type of investments permitted. These restrictions have placed greater emphasis on obtaining competitive investment options and the need for sound investment advice from Council's independent advisor.

Council continues to seek independent advice for all investments and is actively managing the portfolio to ensure that returns are maximised taking into account diversification and risk. A complete analysis of the performance is covered in the Monthly Investment Report prepared by Council's investment advisor (refer to attachment).

The actual investment returns for the year-to-date 31 August 2022 have been reviewed and are $119,000 more than the year-to-date budgeted estimate.

**Summary of Returns from Investments (includes Fair Value adjustments):**

| Year | Original Annual Budget | Revised Annual Budget | YTD Budget (August) | YTD/Annual Actual (August) | YTD/Annual Actual FV adjustments (August) | YTD Budget to Actual Variance (August) |
|---|---|---|---|---|---|---|
| **2021/22** | **$1,290,000** | **$1,290,000** | **$217,700** | $329,700 | $5,000 | **$119,000** |
| 2021/22 | $1,100,000 | $1,300,000 | | $1,244,337 | -$64,865 | $1,179,472 |
| 2020/21 | $1,350,000 | $1,350,000 | | $1,222,664 | $93,735 | -$33,601 |
| 2019/20 | $1,500,000 | $1,529,055 | | $1,896,660 | -$4,944 | $362,661 |

Floating Rate Notes (FRN's) are required to be revalued each month using the Fair Value (FV) method which is an estimate in time of the potential market value of the investment. As of 31 August 2022, the YTD movement of FRN's has been an increase of $5,000.

**Financial Investment Policy**

As at the end of August, all categories were within the Policy limits for credit ratings and the portfolio remains well diversified, with all asset credit quality classified as BBB or higher. The maximum holding limit in each rating category and the target credit quality weighting for Council's portfolio are as per the following table:

| Long Term Rating Range | Invested as 31 August 2022 | Maximum Policy Holding | Distribution as 31 August 2022 |
|---|---|---|---|
| AA Category | $106,136,362 | 100.00% | 65.57% |
| A Category | $38,332,502 | 60.00% | 23.68% |
| BBB Category | $17,406,141 | 35.00% | 10.75% |
| Unrated ADIs (NR) | $0 | 10.00% | 0.00% |

**Loan Borrowings**

Council's Loan Borrowing Policy provides the framework for Council's borrowing activities and defines key responsibilities and the operating parameters within which borrowing and related risk management activities are carried out.

The Policy's objective is to control Council's exposure to movements in interest rates through the application of fixed, floating or a combination thereof to maintain its risk averse strategy.

Loan borrowing will be undertaken in line with the following principles:

a) That the capital cost of infrastructure be recognised over the period during which the benefits will be enjoyed.
b) That loan funds are a resource to fund the replacement and upgrading of existing infrastructure and fund the creation of new infrastructure.
c) That loan funds will be limited to:
   - acquisition or enhancement of income producing assets.
   - construction and/or upgrading of buildings; and
   - infrastructure assets that have a life expectancy of greater than 10 years.

Council has two debt facilities

**Alexander Avenue Carpark and Onstreet Carparking Management System Loan**

This loan is a fixed loan financing option, fully amortising the drawn down amount of $9,500,000 over 10 years, fixed interest rate with quarterly repayments of interest and principal.

The loan details are:

| | | | | |
|---|---|---|---|---|
| **Loan amount:** | $ 9,500,000.00 | | | |
| **Loan term:** | 10 years | | | |
| **From:** | 31/07/2018 | | | |
| **To:** | 31/07/2028 | | | |
| **Interest rate:** | 4.02%p.a.(fixed) | | | |
| **Repayment:** | **Quarterly** | | | |
| | | | | |
| **Dates** | **Principal Outstanding** | **Interest** | **Principal** | **Payment** |
| **1/07/2022** | $6,373,191.95 | | | |
| **29/07/2022** | $6,147,427.51 | $63,875.10 | $225,764.44 | $ 289,639.54 |
| **28/10/2022** | $5,921,431.53 | $63,643.56 | $225,995.98 | $ 289,639.54 |
| **27/01/2023** | $5,691,791.50 | $59,999.51 | $229,640.03 | $ 289,639.54 |
| **28/04/2023** | $5,456,690.24 | $54,538.28 | $235,101.26 | $ 289,639.54 |

The next loan instalment is due on 28 October 2022.

**Loan Funded Capital Projects as at 31 July 2022:**

**Project 1: Upgrading the Car Park in Alexander Street, Crows Nest**
**$5 million** loan was sourced to fund project.

Current length of Loan as per the Long-Term Financial Plan (LTFP): 10 years to 2028

**Project 2: Upgrading of On-Street Parking Management System**
**$4.5 million** loan was sourced to fund project.

Current length of Loan as per LTFP: 10 years to 2028

**Loan for North Sydney Olympic Pool Redevelopment**

In January 2022 Council established a $31 million TCorp loan facility to partially fund the redevelopment of North Sydney Olympic Pool. Drawdown on the facility was processed on 28 April 2022. The drawdown rate is 4.24%. The funds were restricted and will be released as required to fund project cash outflows.

This loan is a fixed loan financing option, fully amortising the drawn down amount of $31,000,000 over 20 years, fixed interest rate with semi-annual repayments of interest and principal.

The loan details are:

| | | | | |
|---|---|---|---|---|
| **Loan amount:** | $ 31,000,000.00 | | | |
| **Loan term:** | 20 years | | | |
| **From:** | 28/04/2022 | | | |
| **To:** | 28/04/2042 | | | |
| **Interest rate:** | 4.24%p.a.(fixed) | | | |
| **Repayment:** | **Semi-Annual** | | | |
| | | | | |
| **Dates** | **Principal Outstanding** | **Interest** | **Principal** | **Payment** |
| **01/07/2022** | $31,000,000 | | | |
| **28/10/2022** | $30,499,987 | $657,200 | $500,013 | $1,157,213 |
| **28/04/2023** | $29,989,375 | $646,600 | $510,613 | $1,157,213 |

The first loan instalment is due on 28 October 2022. At this stage no funds have been applied to the project (internal funding has been used to date) and the entire $31 million is externally restricted.

# Monthly Investment Report

# August 2022

IMPERIUM MARKETS

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***Impact of COVID-19 to Council's Portfolio***

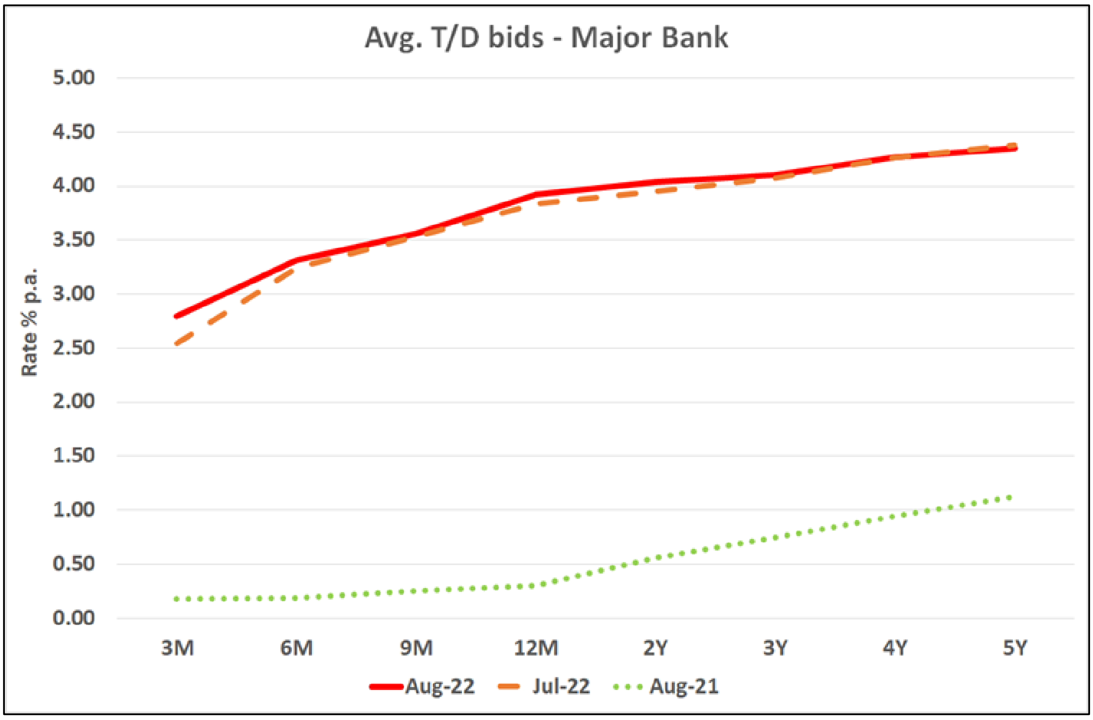
The COVID-19 pandemic has adversely impacted financial markets, which in turn, has also affected Council's investment portfolio. We provide a quick summary in this section.

After global central banks set official interest rates back to emergency levels during the height of the pandemic (2020), financial markets have transitioned to the recovery phase. Ongoing supply chain issues, China's zero-COVID strategy and the war in Ukraine has resulted in surging inflation. Longer-term bond yields have risen significantly in 2022 as central banks undertake aggressive interest rate hikes to try and control inflation. Importantly though when interpreting the stance of monetary policy, it is not just about the cash rate, but how broader financial conditions are influencing the economic outlook, **with markets now factoring the possibility of a global recession as early as the second half of 2023**. **The RBA increased the official cash rate by another 50bp to 1.85% in early August 2022 and is looking to move towards their neutral setting of 2½% by calendar year-end**, although the "*timing of future interest rate increases will be guided by the incoming data and the Board's assessment of the outlook for inflation and the labour market*".

The largest impact to Council's investment portfolio is with regards to its largest exposure being assets held in bank term deposits (fixed and floating), which accounts for around ~81½% of Council's total investment.

Council's term deposit portfolio was yielding 2.21% p.a. at month-end, with a weighted average duration of around 459 days or ~1¼ years. Despite more rate rises to follow, given an upward sloping deposit curve, maintaining a slightly longer duration position will continue to outperform (averaging) shorter durations, particularly as markets have already factored in future rate rises.

The deposit market has seen a significant shift in longer-term deposit rates over the past year. The long-end of the deposit curve (+12 months) remained flat over August (compared to July) despite more rate rises in the near future, and partly driven by the market's expectation of an impending global recession:




*Source: Imperium Markets*

**‘New’ investments above 3½% p.a. now appears likely if Council can place an allocation of its surplus funds for terms of 12 months to 2 years.** *With recessionary fears being priced in coming years, investors may take an insurance policy by investing across 3-5 year fixed deposits and locking in rates above 4½% p.a. (small allocation only).*

# Council's Portfolio & Compliance

## *Asset Allocation*

As at the end of August 2022, the portfolio was mainly directed to fixed and floating rate term deposits (82%). The remaining portfolio is directed to FRNs (2%), fixed bonds (6%) and overnight cash accounts (11%).

**Senior FRNs are now becoming more attractive as spreads have widened over 2022 – new issuances should now be considered again on a case by case scenario**. In the interim, fixed deposits for 12 months to 3 years appear quite appealing following the spike in medium-to longer-term yields with the market already largely factoring in future rate rises. With recessionary fears being priced in coming years, those investors that can allocate longer-term surplus funds may take an insurance policy by investing across 3-5 year fixed deposits and locking in rates above 4½% p.a.

| Code | Number of Trades | Invested | Invested (%) |
|---|---|---|---|
| TD | 41 | 130,250,000.00 | 80.46 |
| CASH | 8 | 17,977,771.54 | 11.11 |
| BOND | 3 | 9,000,000.00 | 5.56 |
| FRN | 6 | 2,647,233.29 | 1.64 |
| FRTD | 1 | 2,000,000.00 | 1.24 |
| **TOTALS** | **50** | **161,875,004.83** | **100.0** |

## *Term to Maturity*

Overall, the portfolio remains lightly diversified from a maturity perspective. Around 29% of assets is directed to medium-term assets (2-5 years), which has resulted in strong outperformance during the challenging low rate environment. There is still high capacity to invest in the short-medium term horizon (1-2 years), with approximately $92m at month-end.

Where liquidity permits, we recommend new surplus funds be directed to 1-2 year horizon given this is where the most attractive value can be found. We suggest this be allocated to any remaining attractive fixed term deposits.

| Compliant | Horizon | Invested ($) | Invested (%) | Min. Limit (%) | Max. Limit (%) | Available ($) |
|---|---|---|---|---|---|---|
| ✓ | 0 - 90 days | $37,977,772 | 23.46% | 10% | 100% | $123,897,233 |
| ✓ | 91 - 365 days | $55,000,000 | 33.98% | 20% | 100% | $106,875,005 |
| ✓ | 1 - 2 years | $21,499,503 | 13.28% | 0% | 70% | $91,813,000 |
| ✓ | 2 - 5 years | $47,397,730 | 29.28% | 0% | 50% | $33,539,772 |
| ✓ | 5 - 10 years | $0 | 0.00% | 0% | 25% | $40,468,751 |
| | | **$161,875,005** | **100.00%** | | | |

## ***Counterparty***

As at the end of August, all individual limits comply with the Policy. Exposures to individual ADIs are driven by the portfolio's movements throughout any month. Overall, the portfolio is well diversified across the investment grade spectrum, with no exposure to the unrated ADIs.

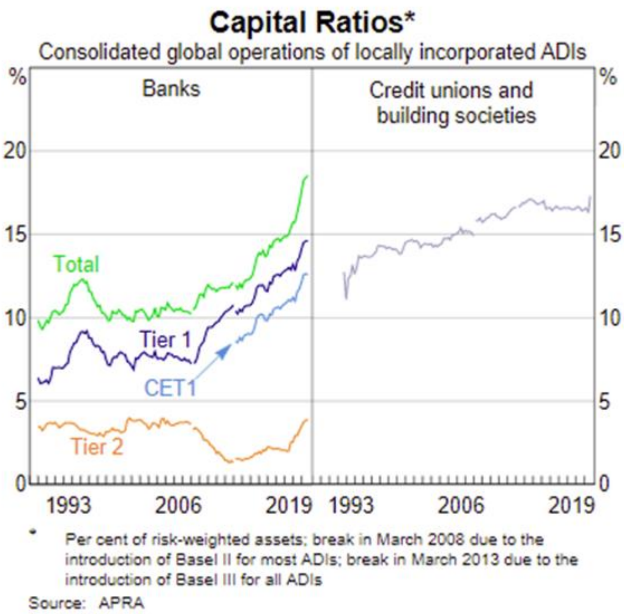
| Compliant | Issuer | Rating | Invested ($) | Invested (%) | Max. Limit (%) | Available ($) |
|---|---|---|---|---|---|---|
| ✓ | CBA | AA- | $34,886,362 | 21.55% | 30.00% | $13,676,139 |
| ✓ | NAB | AA- | $39,000,000 | 24.09% | 30.00% | $9,562,501 |
| ✓ | NTTC Treasury | AA- | $9,000,000 | 5.56% | 30.00% | $39,562,501 |
| ✓ | Westpac | AA- | $23,250,000 | 14.36% | 30.00% | $25,312,501 |
| ✓ | Macquarie | A+ | $15,082,999 | 9.32% | 15.00% | $9,198,252 |
| ✓ | Suncorp | A+ | $6,249,503 | 3.86% | 15.00% | $18,031,748 |
| ✓ | ICBC Sydney | A | $17,000,000 | 10.50% | 15.00% | $7,281,251 |
| ✓ | BOQ | BBB+ | $10,000,000 | 6.18% | 10.00% | $6,187,500 |
| ✓ | AMP Bank | BBB | $6,008,411 | 3.71% | 10.00% | $10,179,090 |
| ✓ | Newcastle PBS | BBB | $1,397,730 | 0.86% | 10.00% | $14,789,770 |
| | | | **$161,875,005** | **100.00%** | | |

In late June 2022, Standard & Poor's downgraded Suncorp-Metway from AA- to A+ (negative watch). Suncorp recently announced that it is undertaking a strategic review of its banking operations. The downgrade reflects S&P's view that the Suncorp Group's likelihood of support for the bank had "*slightly*" diminished and that it was no longer a core part of the Group. In July 2022, ANZ (AA-) announced it was putting a bid to buy Suncorp's banking division for ~$4bn. Should that takeover be formalised, Suncorp-Metway's (A+) current credit rating is likely to be upgraded to ANZ's (AA-).

We remain supportive of the regional and unrated ADI sector (and have been even throughout the GFC period). They continue to remain solid, incorporate strong balance sheets, while exhibiting high levels of capital – typically, much higher compared to the higher rated ADIs. Some unrated ADIs have up to 25-40% more capital than the domestic major banks, and well above the Basel III requirements.

Overall, the lower rated ADIs (BBB and unrated) are generally now in a better financial position then they have been historically (see the Capital Ratio figure below). We believe that deposit investments with the lower rated ADIs should be considered going forward, particularly should they offer 'above market' specials. Not only would it diversify the investment portfolio and reduce credit risk, it would also improve the portfolio's overall returns. The lower rated entities are generally deemed to be the more 'ethical' ADIs compared to the higher rated ADIs.

In the current environment of high regulation and scrutiny, all domestic (and international) ADIs continue to carry high levels of capital. There is minimal (if any) probability of any ADI defaulting on their deposits going forward – this was stress tested during the GFC and the pandemic period. **APRA's mandate is to "*protect depositors*" and provide "*financial stability*".**


Capital Ratios*
Consolidated global operations of locally incorporated ADIs
%
Banks
Credit unions and building societies
%
20
15
10
5
0
Total
Tier 1
CET1
Tier 2
1993
2006
2019
1993
2006
2019
* Per cent of risk-weighted assets; break in March 2008 due to the introduction of Basel II for most ADIs; break in March 2013 due to the introduction of Basel III for all ADIs
Source: APRA

## ***Credit Quality***

The portfolio remains well diversified from a credit ratings perspective, with all assets classified as investment grade (rated BBB- or higher).

Pre-pandemic (March 2020), a 'normal' marketplace meant the lower rated ADIs (i.e. BBB category) were offering higher rates on term deposits compared to the higher rated ADIs (i.e. A or AA rated). But due to the cheap funding available provided by the RBA via their Term Funding Facility (TFF) since mid-2020[1], allowing the ADIs to borrow as low as 0.10% p.a. fixed for 3 years, those lower rated ADIs (BBB rated) did not require deposit funding from the wholesale deposit from the likes of Council. Given the higher rated banks had more capacity to lend (as they have a greater pool of mortgage borrowers), they subsequently were offering higher deposit rates. In fact, some of the lower rated banks were not even offering deposit rates at all. As a result, most investors placed a higher proportion of their deposit investments with the higher rated (A or AA) ADIs over the past two years.

Going forward, with the RBA now removing these cheap borrowing facilities, this has meant the lower rated banks (BBB rated) have started to become more competitive as the market starts to 'normalise'. Investors should have a larger opportunity to start investing a higher proportion of their surplus funds with the lower rated institutions (within Policy limits), from which the majority are considered to be the more ‘ethical’ ADIs as they generally do not lend to the Fossil Fuel industry.

As at the end of August 2022, all categories were within the Policy limits:

| Compliant | Credit Rating | Invested ($) | Invested (%) | Max. Limit (%) | Available ($) |
|---|---|---|---|---|---|
| ✓ | AA Category | $106,136,362 | 65.57% | 100% | $55,738,643 |
| ✓ | A Category | $38,332,502 | 23.68% | 60% | $58,792,501 |
| ✓ | BBB Category | $17,406,141 | 10.75% | 35% | $39,250,111 |
| ✓ | Unrated ADIs | $0 | 0.00% | 10% | $16,187,500 |
| | | **$161,875,005** | **100.00%** | | |

[1] The RBA’s Term Funding Facility (TFF) allowed the ADI to borrow as low as 0.10% fixed for 3 years: https://www.rba.gov.au/mkt-operations/term-funding-facility/overview.html

## *Performance*

Council's performance for the month ending 31 August 2022 is summarised as follows:

| Performance (Actual) | 1 month | 3 months | 6 months | FYTD | 1 year | 2 years |
|---|---|---|---|---|---|---|
| Official Cash Rate | 0.16% | 0.34% | 0.39% | 0.27% | 0.44% | 0.28% |
| AusBond Bank Bill Index | 0.15% | 0.33% | 0.35% | 0.28% | 0.37% | 0.21% |
| Council's T/D Portfolio | 0.17% | 0.40% | 0.69% | 0.30% | 1.33% | 1.41% |
| Council's FRN Portfolio | 0.27% | 0.62% | 0.95% | 0.48% | 1.74% | 1.55% |
| Council's Bond Portfolio | 0.10% | 0.29% | 0.58% | 0.20% | 1.15% | - |
| **Council's Portfolio^** | **0.17%** | **0.40%** | **0.69%** | **0.30%** | **1.33%** | **1.38%** |
| **Outperformance** | **0.01%** | **0.07%** | **0.34%** | **0.02%** | **0.96%** | **1.18%** |

*^Total portfolio performance excludes Council's cash account holdings. Overall returns would be lower if cash was included.*

| Performance (% p.a.) | 1 month | 3 months | 6 months | FYTD | 1 year | 2 years |
|---|---|---|---|---|---|---|
| Official Cash Rate | 1.85% | 1.35% | 0.77% | 1.60% | 0.44% | 0.28% |
| AusBond Bank Bill Index | 1.84% | 1.31% | 0.70% | 1.65% | 0.37% | 0.21% |
| Council's T/D Portfolio | 2.01% | 1.60% | 1.37% | 1.79% | 1.33% | 1.41% |
| Council's FRN Portfolio | 3.21% | 2.49% | 1.89% | 2.85% | 1.74% | 1.55% |
| Council's Bond Portfolio | 1.17% | 1.16% | 1.15% | 1.17% | 1.15% | - |
| **Council's Portfolio^** | **1.98%** | **1.59%** | **1.37%** | **1.78%** | **1.33%** | **1.38%** |
| **Outperformance** | **0.15%** | **0.28%** | **0.67%** | **0.13%** | **0.96%** | **1.18%** |

*^Total portfolio performance excludes Council's cash account holdings. Overall returns would be lower if cash was included.*

For the month of August, the total investment portfolio (excluding cash) provided a strong return of +0.17% (actual) or +1.98% p.a. (annualised), outperforming the benchmark AusBond Bank Bill Index return of +0.15% (actual) or +1.84% p.a. (annualised). The strong performance continues to be driven by the handful of the longer-dated deposits that were locked-in prior to the RBA's rate cuts, as well as the FRNs locked in at attractive margins.

**Over the past year, the total portfolio (excluding cash) returned an outstanding +1.33% p.a., outperforming bank bills by 0.96% p.a**. This has been very strong given deposit rates reached their all-time lows and credit margins have generally contracted over the past 3 years.

**<u>We are pleased that North Sydney Council remains amongst the best performing Councils in the state of NSW where deposits are concerned (as per our May 2022 Council Rankings), earning around $540,000 in additional interest income versus the average NSW Council</u>**. We have been pro-active in our advice about protecting interest income and addressing reinvestment risk for many years and encouraged to maintain a long duration position. This is now reflected by the high performance of the investment portfolio.

## ***Council's Term Deposit Portfolio & Recommendation***

As at the end of August 2022, Council's deposit portfolio was yielding an **attractive 2.21% p.a.** (up 39bp from the previous month), with an average duration of around 459 days (~1¼ years). We recommend Council maintains an average duration above 12 months where possible.

As the past decade or so has highlighted (post-GFC era), we have seen too many portfolios overpay for liquidity and generally not insured themselves by diversify their funding across various tenors. Those investors that can maintain a weighted average duration of +12-18 months are likely to yield, on average, up to ½-1% p.a. higher than those investors who maintain a weighted average duration of less than 6-9 months.

At the time of writing, we see value in:

| ADI | LT Credit Rating | Term | T/D Rate |
|---|---|---|---|
| ICBC, Sydney | A | 5 years | 5.05% p.a. |
| ICBC, Sydney | A | 4 years | 4.90% p.a. |
| ICBC, Sydney | A | 3 years | 4.80% p.a. |
| ICBC, Sydney | A | 2 years | 4.75% p.a. |
| P&N Bank | BBB | 3 years | 4.55% p.a. |
| BoQ/ME | BBB+ | 3 years | 4.50% p.a. |
| Westpac | AA- | 3 years | 4.47% p.a. |
| Australian Military | BBB+ | 2 years | 4.45% p.a. |
| Westpac | AA- | 2 years | 4.43% p.a. |
| CBA | AA- | 2 years | 4.38% p.a. |
| MyState | BBB | 2 years | 4.35% p.a. |
| NAB | AA- | 2 years | 4.30% p.a. |

The above deposits are suitable for investors looking to maintain diversification and lock-in a premium compared to purely investing short-term. For terms under 12 months, we believe the strongest value is currently being offered by the following ADIs (dependent on daily funding requirements):

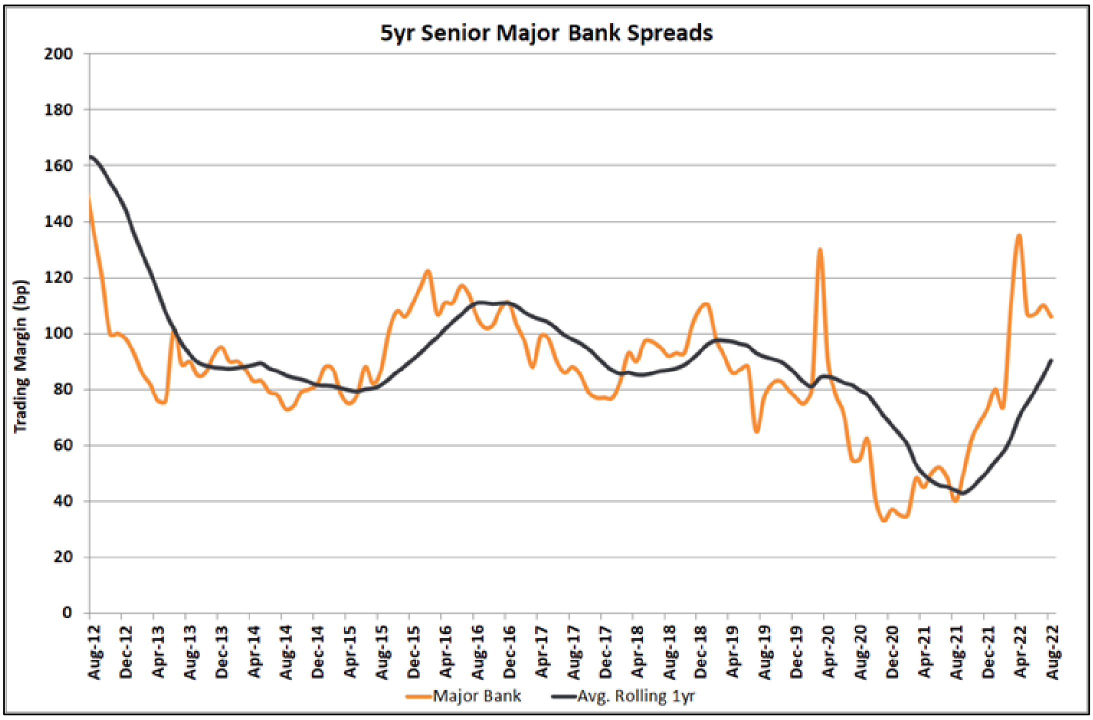
| ADI | LT Credit Rating | Term | T/D Rate |
|---|---|---|---|
| AMP | BBB | 12 months | 4.25% p.a. |
| CBA | AA- | 12 months | 4.18% p.a. |
| Westpac | AA- | 12 months | 4.17% p.a. |
| MyState | BBBB | 12 months | 4.15% p.a. |
| BoQ/ME | BBB+ | 12 months | 4.15% p.a. |
| NAB | AA- | 12 months | 4.10% p.a. |
| Suncorp | A+ | 12 months | 4.10% p.a. |
| ING | A | 12 months | 4.05% p.a. |
| CBA | AA- | 6 months | 3.55% p.a. |

*For those investors that do not require high levels of liquidity and can stagger their investments longer-term, they will be rewarded over coming years if they roll for an average min. term of 18 months to 2 years (this is where we current value), yielding, on average, up to ½%-1% p.a. higher compared to those investors that entirely invest in short-dated deposits*.

*With recessionary fears being priced in coming years, investors may take an insurance policy by investing across 3-5 year fixed deposits and locking in rates above 4½% p.a. (small allocation only).*

<u>***Senior FRNs Review***</u>

Over August, amongst the senior major bank FRNs, physical credit securities tightened by around 4-5bp at the long-end of the curve. Major bank senior securities are now looking fairly attractive again in a rising rate environment (5 year margins around the +105-110bp level):




*Source: IBS Capital*

There was a noticeable pick-up in primary ('benchmark') issuances over August:

- Westpac (AA-) 3yr fixed and floating at +80bp
- CBA (AA-) 3 & 5yr fixed and floating at +80bp and +102bp respectively
- Suncorp (A+) 3yr fixed and floating at +93bp
- Mizuho (A) 3yr floating at +88bp
- HSBC (AA-) 5yr floating at +110bp
- Macquarie (A+) 1yr floating at +55bp

Amongst the "A" and "BBB" rated sectors, the securities were marked around 5bp tighter at the 3-5 year part of the curve. Credit securities are looking much more attractive given the widening of spreads in 2022. FRNs will continue to play a role in investor's portfolios mainly on the basis of their liquidity and the ability to roll down the curve and gross up returns over ensuing years (in a relatively stable credit environment).

| Senior FRNs (ADIs) | 31/08/2022 | 31/07/2022 |
|---|---|---|
| "AA" rated – 5yrs | +106bp | +110bp |
| "AA" rated – 3yrs | +82bp | +88bp |
| "A" rated – 5yrs | +120bp | +125bp |
| "A" rated – 3yrs | +95bp | +100bp |
| "BBB" rated – 3yrs | +125bp | +130bp |

*Source: IBS Capital*

We now generally recommend switches ('benchmark' issues only) into new primary issues, out of the following senior FRNs that are maturing:

- **On or before mid-2024 for the "AA" rated ADIs (domestic major banks)**;
- On or before mid-2023 for the "A" rated ADIs; and
- Within 6-9 months for the "BBB" rated ADIs (consider case by case).

Investors holding onto the above senior FRNs ('benchmark' issues only) in their last few years are now generally holding sub-optimal investments and are not maximising returns by foregoing realised capital gains. In the current low interest rate environment, any boost in overall returns should be locked in when it is advantageous to do so, particularly as switch opportunities become available.

*Primary (new) FRNs are now looking more appealing and should be considered on a case by case scenario.*

***Council's Senior FRNs Sale/Switch Recommendations***

We recommend Council retains its remaining two FRNs at this stage. We will inform Council when there is an opportunity to sell these assets to boost the overall returns of the investment portfolio.

***Council's Senior Bonds***

During October 2020, Council placed two parcels of $3m (totalling $6m) with the Northern Territory Treasury Corporation (NTTC), locking in yields of 0.90% p.a. and 1.00% p.a. for a 4 and 5 year term respectively. In August 2021, it placed another $3m parcel with NTTC (AA-), locking in a yield of 1.50% p.a. for a 5 year term.

Council received the full rebated commission of 0.25% on the total face value of investments (i.e. $9m x 0.25% = $22,500) as it was introduced by Imperium Markets. We believe these investments were prudent at the time of investment given the low rate environment and especially after the rate cut delivered in early November 2020 and the RBA's forward guidance on official interest rates (no rate rises "*until at least 2024*").

The NTTC bonds are a 'retail' offering and not 'wholesale' issuances. Given the lack of liquidity and high penalty costs if they were to be sold/redeemed prior to the maturity date, they are considered to be a hold-to-maturity investment and will be marked at par value ($100.00) throughout the term of investment.

## *Senior Fixed Bonds – ADIs (Secondary Market)*

As global inflationary pressures have escalated, this has seen a significant lift in longer-term bond yields (valuations fell) as markets have reacted accordingly.

This has resulted in some opportunities in the secondary market. We currently see value in the following fixed bond lines, with the majority now being marked at a significant discount to par (please note supply in the secondary market may be limited on any day):

| ISIN | Issuer | Rating | Capital Structure | Maturity Date | ~Remain. Term (yrs) | Fixed Coupon | Indicative Yield |
|---|---|---|---|---|---|---|---|
| AU3CB0255776 | ING | AAA | Covered | 07/09/2023 | 1.02 | 3.00% | 4.09% |
| AU3CB0258465 | Westpac | AA- | Senior | 16/11/2023 | 1.21 | 3.25% | 4.11% |
| AU3CB0265403 | Suncorp | AA- | Senior | 30/07/2024 | 1.91 | 1.85% | 4.60% |
| AU3CB0265593 | Macquarie | A+ | Senior | 07/08/2024 | 1.95 | 1.75% | 4.63% |
| AU3CB0265718 | ING | AAA | Covered | 20/08/2024 | 1.97 | 1.45% | 4.39% |
| AU3CB0266179 | ANZ | AA- | Senior | 29/08/2024 | 1.99 | 1.55% | 4.40% |
| AU3CB0266377 | Bendigo | BBB+ | Senior | 06/09/2024 | 2.01 | 1.70% | 4.64% |
| AU3CB0268027 | BoQ | BBB+ | Senior | 30/10/2024 | 2.17 | 2.00% | 4.78% |
| AU3CB0269710 | ANZ | AA- | Senior | 16/01/2025 | 2.38 | 1.65% | 4.48% |
| AU3CB0269892 | NAB | AA- | Senior | 21/01/2025 | 2.38 | 1.65% | 4.45% |
| AU3CB0270387 | Macquarie | A+ | Senior | 12/02/2025 | 2.45 | 1.70% | 4.82% |
| AU3CB0287415 | Westpac | AA- | Senior | 17/03/2025 | 2.54 | 2.70% | 4.45% |
| AU3CB0291508 | Westpac | AA- | Senior | 11/08/2025 | 2.94 | 3.90% | 4.42% |
| AU3CB0291672 | CBA | AA- | Senior | 18/08/2025 | 2.96 | 4.20% | 4.70% |
| AU3CB0280030 | BoQ | BBB+ | Senior | 06/05/2026 | 3.68 | 1.40% | 5.13% |
| AU3CB0282358 | ING | AAA | Covered | 19/08/2026 | 3.97 | 1.10% | 4.74% |
| AU3CB0284149 | BoQ | BBB+ | Senior | 27/10/2026 | 4.15 | 2.10% | 5.12% |
| AU3CB0286037 | Westpac | AA- | Senior | 25/01/2027 | 4.40 | 2.40% | 4.70% |

# Economic Commentary

Financial markets remained volatile over August, reflecting shifting market expectations around central bank policy rates given competing forces of persistent inflation and slowing economic growth.

The US Federal Reserve delivered a stern warning that the central bank's campaign to lower inflation by raising interest rates is "*unconditional*" even if it leads to pain for households, businesses and, in turn, stock prices.

In the US, the S&P 500 Index fell -4.24%, while the NASDAQ lost -4.64%. Europe's main indices were also sold off, led by France's CAC (-5.02%), Germany's DAX (-4.81%) and UK's FTSE (-1.88%).

US CPI came in slightly lower than expected. Headline inflation was 0.0% m/m vs. +0.2% expected and core inflation was +0.3% m/m vs. +0.5% expected.

The US unemployment rate dropped from 3.6% to 3.5%, matching its pre-pandemic low, partly driven by a 0.1% fall in the participation rate to 62.1%.

UK's inflation came in higher than expected at +10.1% y/y against +9.8% expected, with more to come in October when energy bills are set to rise by 75%. Food prices rose +2.3% in July and +12.3% y/y.

The Bank of England hiked rates by 50bp to 1.75%, its largest hike in 27 years, taking the Bank Rate back to pre-GFC levels. The Bank now expects headline inflation to peak at 13.3% in October and to remain at elevated levels throughout much of 2023, before falling to its 2% target in 2025. The UK is forecast to enter recession from the fourth quarter of 2022, and the recession is expected to last for five quarters.

Canada's CPI inflation showed the expected cooling of the headline rate, down to +7.6% y/y, but core measures continued to rise, with the three key measures all rising to reach a +5-5½% range.

The RBNZ raised its overnight cash rate by 50bp to 3.00%, as universally expected. The RBNZ also slightly lifted its forecast for the cash rate to peak at 4.1% next year (previously 3.95%) and signalled a high chance of 50bp hikes at each of the next two meetings in October and November.

The MSCI World ex-Aus Index fell -4.39% for the month of August:

| Index | 1m | 3m | 1yr | 3yr | 5yr | 10yr |
|---|---|---|---|---|---|---|
| S&P 500 Index | -4.24% | -4.29% | -12.55% | +10.56% | +9.86% | +10.89% |
| MSCI World ex-AUS | -4.39% | -5.82% | -16.46% | +7.22% | +6.17% | +7.67% |
| S&P ASX 200 Accum. Index | +1.18% | -2.39% | -3.43% | +5.51% | +8.13% | +9.34% |

*Source: S&P, MSCI*

## ***Domestic Market***

As expected, the RBA raised the official cash rate by 50bp to 1.85%, the third consecutive 50bp increase. The Statement repeated that "*the Board expects to take further steps in the process of normalising monetary conditions over the months ahead*", but also added policy "*is not on a pre-set path*". The RBA is still prioritising achieving a soft landing if inflation expectations remain anchored as they currently believe it to be.

The RBA's Minutes flagged further hikes are on the way ("t*he Board expects to take further steps in the process of normalising monetary conditions over the months ahead*"), but is ambiguous thereafter as was the post-Meeting Statement. The RBA only sees core inflation falling to 3% in 2024, while wages growth is expected to be 3.9%.

The headline wage price index (WPI) excluding bonuses number printed at +0.7% q/q and +2.6% y/y, revealing a continued acceleration in wages growth alongside the earlier tightening in the labour market.

The July unemployment rate fell by 0.1% to 3.4% (consensus 3.5%), partially driven by the participation rate falling by 0.3% to 66.4%. Overall, employment fell sharply by -41k in July following the sharp rise of +88k in June.

The trade surplus came in at $17.7bn in June, up from a downwardly revised $15bn May number, well outpacing consensus forecasts for a fall to $14bn. The increase in the month was driven by a +5.1% rise in export values, led by iron ore, rural exports, and volatile non-monetary gold exports. Imports also rose in the month, up +0.7%.

Australian dwelling prices fell -1.3% m/m in July according to CoreLogic data as the pace of declines accelerated in the largest cities. Dwelling prices nationally are now 2.0% below their April peak but remain 23.3% higher than pre-pandemic April 2020 levels.

The Australian dollar fell -1½%, finishing the month at US69.02 cents (from US70.07 cents the previous month).

## ***Credit Market***

The global credit indices marginally widened over the month as risk markets were again largely sold off. They are back to their levels experienced during the start of the pandemic (Q1 2020):

| Index | August 2022 | July 2022 |
|---|---|---|
| CDX North American 5yr CDS | 92bp | 83bp |
| iTraxx Europe 5yr CDS | 120bp | 110bp |
| iTraxx Australia 5yr CDS | 109bp | 123bp |

*Source: Markit*

# Fixed Interest Review

## ***Benchmark Index Returns***

| Index | August 2022 | July 2022 |
|---|---|---|
| Bloomberg AusBond Bank Bill Index (0+YR) | +0.15% | +0.14% |
| Bloomberg AusBond Composite Bond Index (0+YR) | -2.54% | +3.36% |
| Bloomberg AusBond Credit FRN Index (0+YR) | +0.35% | +0.24% |
| Bloomberg AusBond Credit Index (0+YR) | -1.42% | +2.40% |
| Bloomberg AusBond Treasury Index (0+YR) | -2.74% | +3.55% |
| Bloomberg AusBond Inflation Gov’t Index (0+YR) | -2.61% | +4.75% |

*Source: Bloomberg*

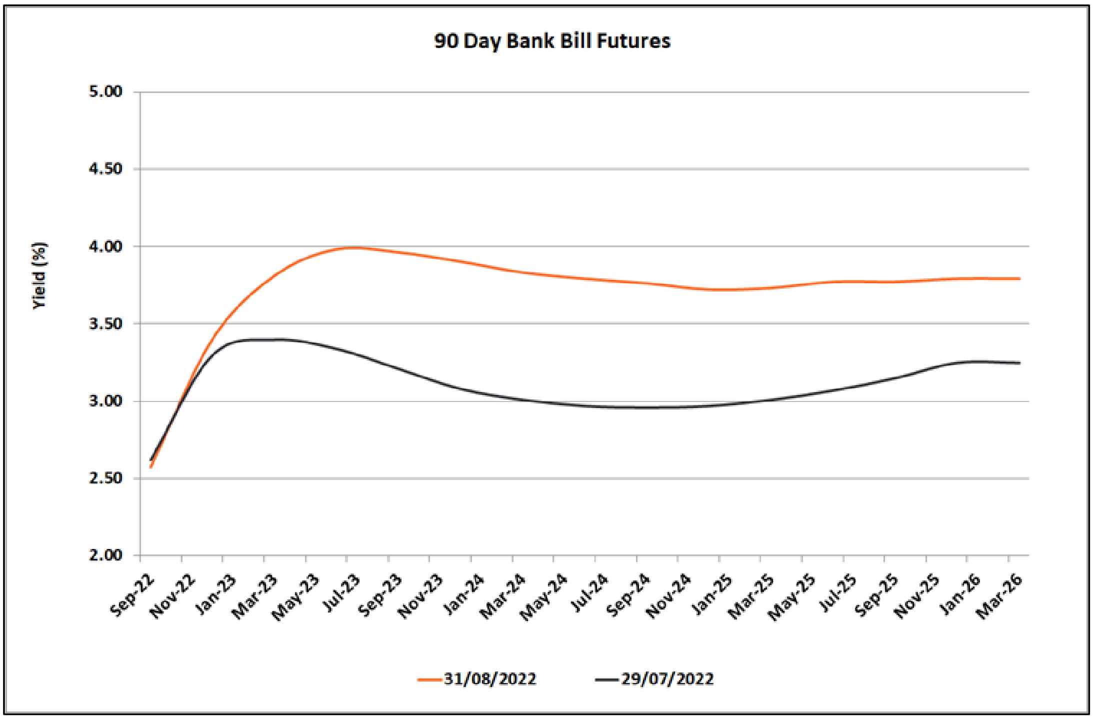
## ***Other Key Rates***

| Index | August 2022 | July 2022 |
|---|---|---|
| RBA Official Cash Rate | 1.85% | 1.35% |
| 90 Day (3 month) BBSW Rate | 2.46% | 2.12% |
| 3yr Australian Government Bonds | 3.25% | 2.70% |
| 10yr Australian Government Bonds | 3.60% | 3.06% |
| US Fed Funds Rate | 2.25%-2.50% | 2.25%-2.50% |
| 3yr US Treasury Bonds | 3.46% | 2.83% |
| 10yr US Treasury Bonds | 3.15% | 2.67% |

*Source: RBA, AFMA, US Department of Treasury*

## *90 Day Bill Futures*

Over August, bill futures rose across the board reacting to global central banks commentary suggesting they are still some time away before pivoting away from their hawkish stance. The markets continue to factor in the possibility of a global recession over the next few years, highlighted by the drop in the futures pricing in 2023-2024:




*Source: ASX*

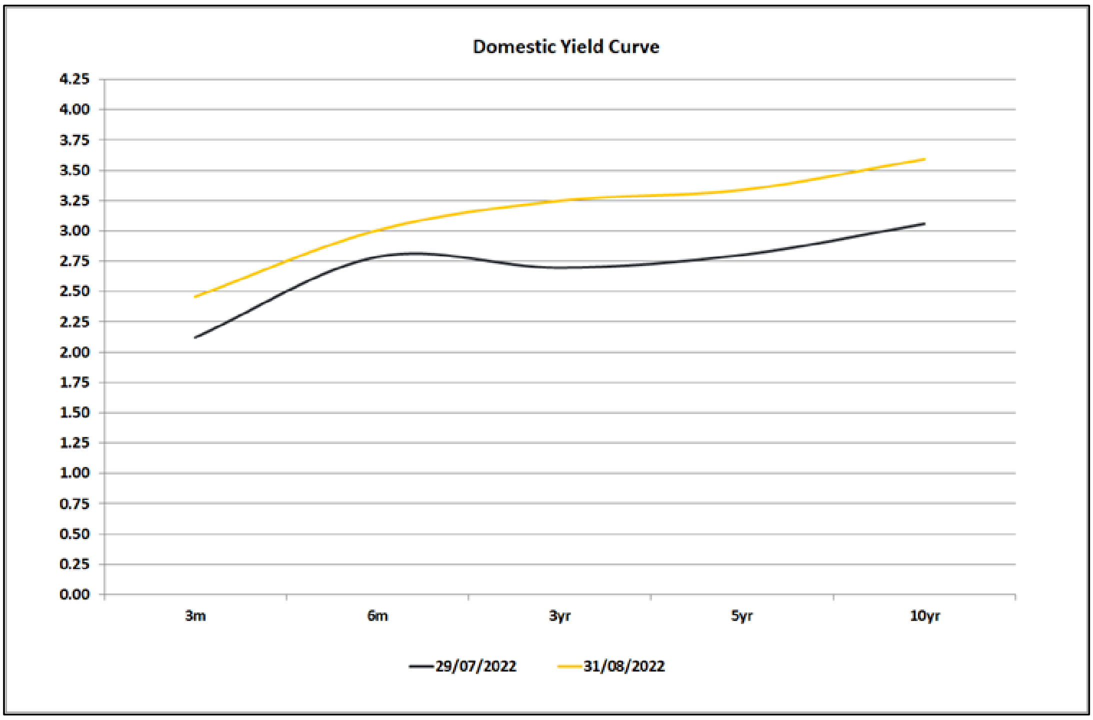
# Fixed Interest Outlook

The US Federal Reserve delivered a stern warning that the central bank's campaign to lower inflation by raising interest rates is "*unconditional*" even if it leads to pain for households, businesses and, in turn, stock prices. Another 50bp hike is all but priced into their next meeting on 21st September, with the market now factoring a 75bp hike being more likely.

Domestically, the RBA's inflation forecasts were revised higher with inflation set to peak at 7.75% over 2022, remain high at 4% in 2023 and around 3% over 2024. While there is near-term uncertainty over the pace of additional rate hikes, on these forecasts, the RBA has little room to cut rates in 2023 as the market is currently pricing.

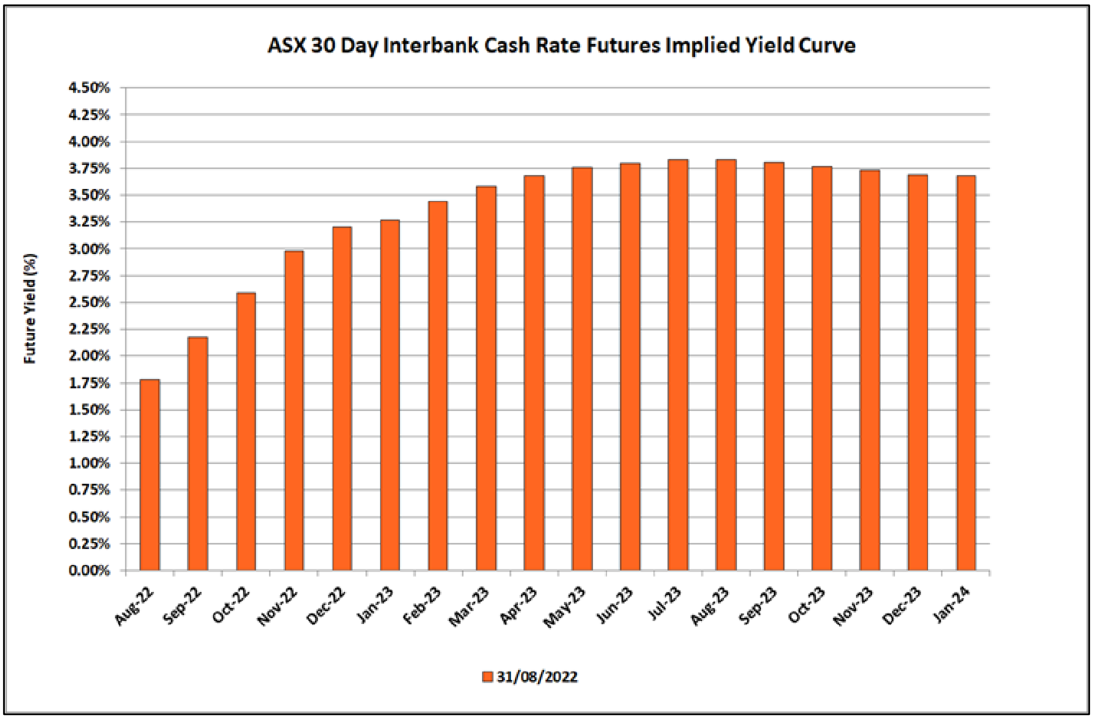
The speed of the RBA's rate rises in recent months reflects the need to rapidly recalibrate policy from emergency levels near zero to somewhat restrictive levels over a reasonably short period. The speed of the moves should help contain medium-term inflationary expectations, which the Bank continues to assess as well anchored.

The domestic bond market continues to suggest a prolonged low period of interest rates on a historical basis (10-year government bond yields just over 3½%). Over the month, yields rose up to 55bp at the long-end of the curve:




*Source: AFMA, ASX, RBA*

Markets are currently pricing in around 7-8 additional rate rises over the next two years (up to 3¾%), against the RBA's neutral setting of 2½%. Fears of a looming global recession have actually seen rate cuts start to be priced in towards the second half of 2023, although this seems unlikely for now**:**




*Source: ASX*

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