Report to General Manager

Attachments:
1. Monthly Investment Report as at 31 August 2019

SUBJECT: Investments and Loan Borrowings Held as at 31 August 2019

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ENDORSED BY: Margaret Palmer, Director Corporate Services

EXECUTIVE SUMMARY:

This report provides details of the performance of Council's investment portfolio and borrowing limits for the period ending 31 August 2019.

Investment Portfolio:

The performance of the Investment portfolio excluding cash deposits provided an annualised return of 2.97% for the year to date as at 31 August 2019, 1.15% above the reportable benchmark (BBSW Bank Bill Index). Interest returns remain consistently above the benchmark.

Borrowings:
Council has entered into a principal and fixed loan of $9.5 million.

FINANCIAL IMPLICATIONS:

The 2019/20 budgeted returns on investments is estimated to be $1,500,000.00. This is significantly less than previous returns due to the declining cash reserve balances and continued low interest rates. Any surplus funds generated in excess of adopted estimates will be transferred to Council's internally restricted reserves.

Comment by Responsible Accounting Officer:
Investments and Loan borrowings funding comply with Council's Financial Management Policy.

RECOMMENDATION:
1. THAT the report on Investments and Loan Borrowings held as at 31 August 2019 be received (This report was provided to the Governance & Finance Committee on 9 September 2019 for information).

LINK TO COMMUNITY STRATEGIC PLAN

The relationship with the Community Strategic Plan is as follows:

Direction: 5. Our Civic Leadership

Outcome: 5.1 Council leads the strategic direction of North Sydney

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.

SUSTAINABILITY STATEMENT

The following table provides a summary of the key sustainability implications:

QBL Pillar	Implications
Environment	• There are no perceived short or long-term environmental implications.
Social	• There are no perceived short or long-term social implications.
Economic	• Provides Council with a significant source of income.
Governance	• Compliance with all legislative requirements and statutory obligations.

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 2019 and annualized for the year to date as at 31 August 2019 (including investments which have matured prior to 31 August 2019).

	August 2019	**Annualised YTD as at 31 August 2019**
Actual Return	0.21%	2.97%
Benchmark	0.08%	1.82%
Variance	0.13%	1.15%

Investment Performance
Investment returns continue to exceed the indicative benchmark (BBSW 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. Further, 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 attachment 1.)

The actual investment returns for the year to date as at 31 August 2019 have been reviewed and are $77,142 greater than the revised budget.

Summary of Returns from Investments:

Year	Original Annual Budget	Revised Annual Budget	YTD Budget (August)	YTD/Annual Actual (August)	YTD Budget to Actual Variance (August)
2019/20	**$1,500,000**	**$1,500,000**	**$266,000**	**$343,142**	**$77,142**
2018/19	$1,590,000	$1,730,000		$2,253,497	$523,497
2017/18	$2,300,000	$2,490,000		$2,589,813	$99,813
2016/17	$2,000,000	$3,000,000		$3,276,518	$276,518
2015/16	$2,320,000	$3,640,000		$4,105,146	$465,146
2014/15	$3,400,000	$4,150,000		$4,414,692	$264,692
2013/14	$2,700,000	$3,400,000		$3,983,515	$583,515
2012/13	$2,000,000	$2,887,751		$4,238,785	$1,353,069
2011/12	$2,000,000	$3,400,000		$3,728,080	$328,080

Financial Investment Policy

The maximum holding limit in each rating category and the target credit quality weighting for Council's portfolio shall be:

Long Term Rating Range	Maximum Holding
AAA Category	100.00%
AA Category	100.00%
A Category	60.00%
BBB Category	35.00%
Unrated ADIs (NR)	10.00%

Loan Borrowings

Council's Debt Management 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 to be 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 of both in order 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.

The current Debt Facility is as follows:

The current facility is a fixed loan financing option, fully amortising the drawn down amount of $9,500,000.00 over 10 years, fixed interest rate with quarterly repayments of interest and principal.

The current loan details are as follows:

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**
1/07/2019	**$ 8,910,951.91**			
31/7/2019	**$ 8,711,603.51**	**$ 90,291.14**	**$ 199,348.40**	**$ 289,639.54**

The next loan instalment is due on 31 October 2019.

Loan Funded Capital Projects as at 31 August 2019:

Project 1: Upgrading the Car Park in Alexander Street, Crows Nest
A **$5 million** loan has been sourced to fund this project.
Current length of Loan as per LTFP: 10 years to 2028

Project 2: Upgrading of On-Street Parking Management System
A **$4.5 million** loan has been sourced to fund this project.
Current length of Loan as per LTFP: 10 years to 2028

Monthly Investment Report

August 2019

IMPERIUM MARKETS

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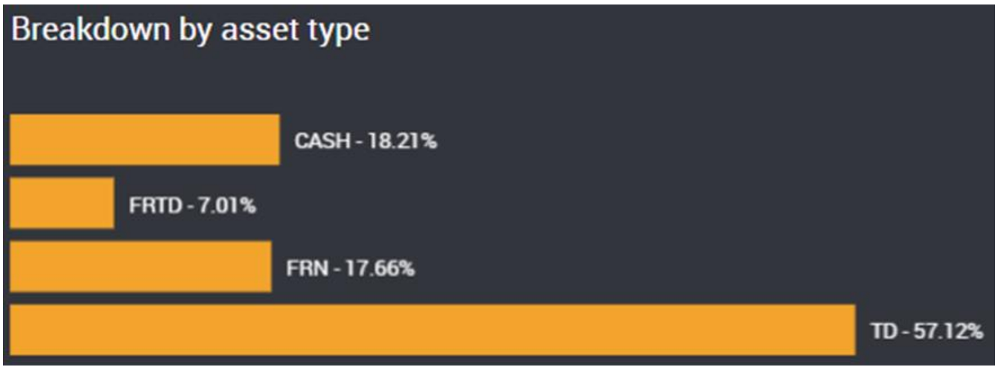
Council's Portfolio & Compliance

Asset Allocation

As at the end of August 2019, the portfolio was mainly directed to fixed and floating rate term deposits (59%). The remaining portfolio is directed to FRNs (18%) and overnight cash accounts (18%).

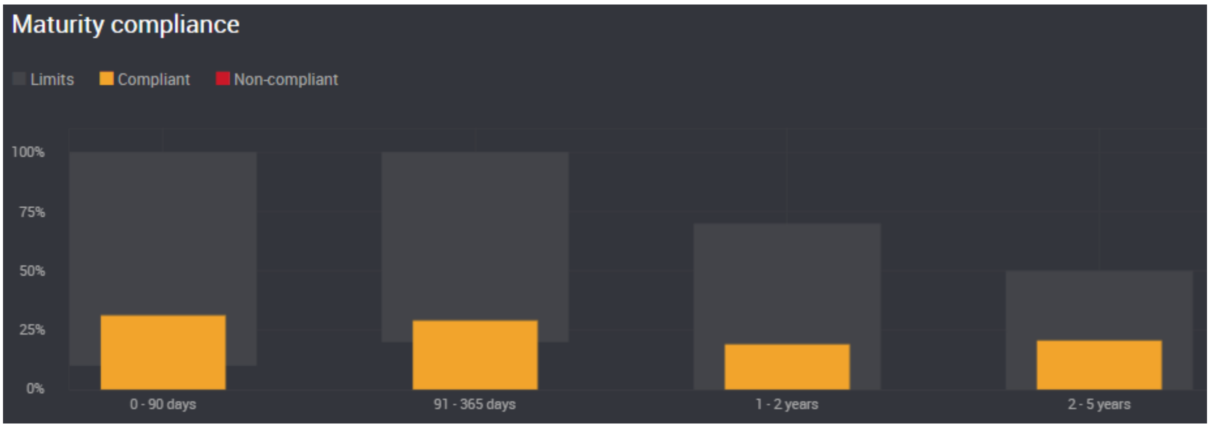
Should credit securities become more attractive relative to deposits, Council may increase its allocation to liquid senior floating rate notes (FRNs). This will not only offer potential upside with regards to the portfolio's investment returns, but also provide additional liquidity (FRNs are saleable – generally accessible within 2 business days). With further rate cuts on the horizon, the priority is now to lock in any remaining attractive medium-longer dated fixed deposits that may be available in the market.



Term to Maturity

Overall, the portfolio remains lightly diversified from a maturity perspective with around 21% of assets directed to medium-term (2-5 years). There is now high capacity to invest in the medium-term horizon (2-5 years) following the capital outflows experienced over 2017-2018.

All minimum and maximum limits comply with the Policy:



Where liquidity permits, we recommend new surplus funds be directed to 2-5 year horizons given this is where the most attractive value can be found. We suggest this be allocated to new senior FRN issues and fixed/floating rate term deposits (refer to respective sections below).

Compliant	Horizon	Invested ($)	Invested (%)	Min. Limit (%)	Max. Limit (%)	Available ($)
✓	0 – 90 days	$31,174,387	31.24%	10%	100%	$68,618,263
✓	91 – 365 days	$29,009,410	29.07%	20%	100%	$70,783,240
✓	1 – 2 years	$19,005,850	19.05%	0%	70%	$50,849,005
✓	2 – 5 years	$20,603,003	20.65%	0%	50%	$29,293,322
✓	5 – 10 years	$0	0.00%	0%	25%	$24,948,163
		$99,792,650	**100.00%**			

Counterparty

As at the end of August, all counterparties were within Policy limits, expect for AMP Bank by ~$1.1m. This can easily be rectified as approximately $3.1m is held in a 31-day Cash Notice Account.

On 27th August, AMP Bank was downgraded by ratings agency S&P to BBB+ (negative watch), from A- (negative watch). Their short-term rating was unchanged at A-2. This was a result of AMP Group selling its life insurance arm at a revised deal earlier in the month. S&P believed that the group's profits will be less diversified going forward due to this sale. We have no issues with Council's exposure to AMP Bank given they continue to have a robust balance sheet with their level of capital remaining above the minimum regulatory requirement set by APRA.

Overall, the portfolio is well diversified across the entire credit spectrum, including some exposure to the unrated ADIs.

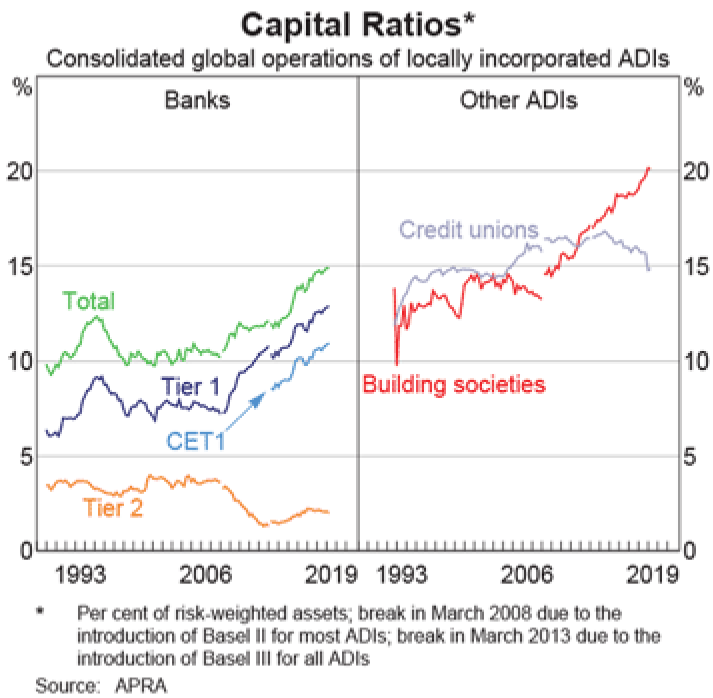
Compliant	Issuer	Rating	Invested ($)	Invested (%)	Max. Limit (%)	Available ($)
✓	ANZ	AA-	$2,026,546	2.03%	30.00%	$27,911,249
✓	CBA (BankWest)	AA-	$17,095,263	17.13%	30.00%	$12,842,532
✓	NAB	AA-	$23,044,030	23.09%	30.00%	$6,893,765
✓	Westpac	AA-	$15,000,000	15.03%	30.00%	$14,937,795
✓	Suncorp	A+	$7,244,183	7.26%	15.00%	$7,724,715
X	AMP Bank	BBB+	$11,119,528	11.14%	15.00%	**-$1,140,263**
✓	BOQ	BBB+	$8,000,000	8.02%	10.00%	$1,979,265
✓	Bendigo	BBB+	$2,000,272	2.00%	10.00%	$7,978,993
✓	Auswide Bank	BBB	$3,000,000	3.01%	10.00%	$6,979,265
✓	Newcastle PBS	BBB	$4,009,410	4.02%	10.00%	$5,969,855
✓	ME Bank	BBB	$3,253,419	3.26%	10.00%	$6,725,846
✓	The Mutual	Unrated	$3,000,000	3.01%	5.00%	$1,989,633
✓	WAW CU	Unrated	$1,000,000	1.00%	5.00%	$3,989,633
			$99,792,650	**100.00%**		

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.

APRA's Chairman affirmed that the banks had satisfactorily moved towards an '*unquestionably strong*' capital position and that bank's stress testing contingency plans were now far better positioned that was previously the case years ago. APRA's stress test which hypothetically increased the unemployment rate to 11% (more than double the current rate) and for house prices to fall 35% showed the banks remained above the minimum capital levels. We note that APRA's discussion paper also highlighted that the domestic major banks were required to raise more capital while the lower rated ADIs were already deemed to be at a satisfactory level.

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 continued going forward, particularly when 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.

In the current environment of high regulation and scrutiny, all domestic ADIs continue to carry high levels of capital, particularly amongst the lower ("BBB") and unrated ADIs. There is minimal (if any) probability of any ADI defaulting on their deposits going forward – this was stress tested during the GFC.



The biggest single risk that depositors face in the current low interest rate environment is not credit risk, but reinvestment risk.

Credit Quality

The portfolio remains well diversified from a credit ratings perspective. As at the end of August 2019, all categories were compliant within the Policy limits.

From a ratings perspective, the BBB rated entities now generally dominate the number of ADIs issuing deposits within the investment grade space. We anticipate more investors will naturally allocate a higher proportion of their assets into this sector (on a historical basis), considering the most attractive assets from senior debt securities are generally offered by these ADIs.

Council may consider lifting the aggregate limit with the BBB and unrated ADI category at its next policy review.

Compliant	Credit Rating	Invested ($)	Invested (%)	Max. Limit (%)	Available ($)
✓	AA Category	$57,165,839	57.28%	100%	$42,626,811
✓	A Category	$7,244,183	7.26%	60%	$52,631,408
✓	BBB Category	$31,382,629	31.45%	35%	$3,544,799
✓	Unrated ADIs	$4,000,000	4.01%	10%	$5,979,265
		$99,792,650	**100.00%**		

Performance

Council's performance for the month ending 31 August 2019 is summarised as follows:

Performance	1 month	3 months	6 months	FYTD	1 year
Official Cash Rate	0.08%	0.27%	0.65%	0.17%	1.39%
AusBond Bank Bill Index	0.08%	0.34%	0.82%	0.20%	1.82%
Council's T/D Portfolio	0.22%	0.66%	1.37%	0.44%	2.95%
Council's FRN Portfolio	0.19%	0.61%	1.37%	0.39%	3.03%
Council's Portfolio^	**0.21%**	**0.65%**	**1.37%**	**0.43%**	**2.97%**
Outperformance	**0.13%**	**0.31%**	**0.55%**	**0.22%**	**1.15%**

^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 +0.21% (actual), outperforming the benchmark AusBond Bank Bill Index return of +0.13% (actual). 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.

However, the majority of the high-yielding deposits are fast maturing and will be reinvested at lower prevailing rates. With deposit margins tightening over the past few years, the FRN portfolio has now started to outperform deposits as shown in the past 12 months returns.

Over the past 12 months, the total portfolio (excluding cash) returned an outstanding +2.97% p.a., outperforming bank bills by 1.15% 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.

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 June 2019 Council Rankings), earning on average, more than $350,000 in additional interest income compared to its peers. 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. Of the 22 individual deposits North Sydney Council held, 12 are still yielding higher than 2.50% p.a. That is, around 55% of outstanding deposits held is earning more than 2½ times the prevailing cash rate of 1.00%.

Investors using the Imperium Markets platform have reduced the invisible costs associated with brokerage, and thereby lift client portfolio returns as investors are able to deal in deposits directly with the ADIs and execute at the best price possible. Council has experienced this first hand with its first trades executed in July and August, earning between 4-6bp above direct rate sheets from the banks.

Council's Term Deposit Portfolio & Recommendation

As at the end of August 2019, Council's deposit portfolio was yielding an **attractive 2.44% p.a. (down 16bp from the previous month)**, with an average duration of around 358 days (~12 months).

Where possible, we recommend Council extends this average duration. In the low interest rate environment, the biggest collective risk that the local government sector has faced over the post-GFC era has been the dramatic fall in interest rates - from 7¼% to the current historical low levels of 1.00% (and potentially lower).

As the past decade has highlighted (post-GFC), we have seen too many portfolios' roll a high proportion of their deposits between 3-6 months, resulting in their deposits being reinvested at lower prevailing rates. That is, depositors have generally not insured themselves against the low interest rate environment by diversify their funding across various tenors (out to 5 years) but rather placed all their 'eggs in one basket' and kept all their deposits short. **Reinvestment risk has collectively been and continues to be the biggest detriment to depositors' interest income over the post-GFC period**. **Additional interest rate cuts remain a strong possibility over the next 6 months**.

At the time of writing (early September), we see value in:

ADI	LT Credit Rating	Term	T/D Rate
BoQ	BBB+	5 years	2.00% p.a.
BoQ	BBB+	4 years	1.90% p.a.
AMP Bank	BBB+	2-4 years	^1.90% p.a.
BoQ	BBB+	3 years	1.80% p.a.
Auswide Bank	BBB	3-5 years	~1.80% p.a.
Auswide Bank	BBB	1½ - 2 years	~1.75% p.a.
BoQ	BBB+	2 years	1.70% p.a.

^ AMP T/Ds – these are grossed up rates which includes a 0.20% p.a. rebated commission from Imperium Markets

For those investors that have capacity issues with the "BBB" and unrated ADI sector, we see value in:

ADI	LT Credit Rating	Term	T/D Rate
ICBC, Sydney Branch	A	2 years	~1.62% p.a.
Westpac	AA-	2 years	~1.50% p.a.
Macquarie Bank	A	2 years	1.50% p.a.

The above deposits are suitable for investors looking to provide some income protection and mitigate reinvestment/rollover risk in the low interest rate environment, and particularly with further interest rate cuts imminent on the horizon.

For terms under 12 months, we believe the strongest value is currently being offered by a number of lower and unrated ADIs offering above-market specials (dependent on daily funding requirements):

ADI	LT Credit Rating	Term	T/D Rate
AMP Bank	BBB+	6 months	^2.20% p.a.
AMP Bank	BBB+	7-12 months	^2.00% p.a.
BoQ	BBB+	6 months	1.70% p.a.
Auswide Bank (rollovers only)	BBB	3 months	1.70% p.a.
ME Bank	BBB	3-5 months	1.70% p.a.
ME Bank	BBB	6 months	1.67% p.a.
ME Bank	BBB	7-12 months	1.65% p.a.

^ AMP T/Ds – these are grossed up rates which includes a 0.20% p.a. rebated commission from Imperium Markets

Amongst the higher rated ADIs ("A" rated or higher), the following deposits remain attractive for terms under 12 months:

ADI	LT Credit Rating	Term	T/D Rate
Macquarie Bank	A	3-4 months	1.85% p.a.
Macquarie Bank	A	6 months	1.80% p.a.
Macquarie Bank	A	9 months	1.65% p.a.
Westpac	AA-	12 months	~1.58% p.a.
NAB	AA-	12 months	1.55% p.a.
CBA	AA-	12 months	1.55% p.a.

IMPERIUM MARKETS

Senior FRNs Review

Over August, amongst the senior major bank FRNs, physical credit securities parred back some of their gains experienced in July. During the month, ANZ (AA-) launched a dual 3 and 5 year senior FRN at +58bp and +77bp respectively, which we thought was offered at fair value compared to secondary market equivalents.

Those investors that require liquidity with a domestic major bank (highly rated) and can roll down the curve should invest in 5 year terms over 3 year terms (or shorter), given the ability to lock in capital gains as early as two years after being launched. **The grossed up return would be closer to around +105-110bp over a 2 year holding period in a relatively stable credit environment**.

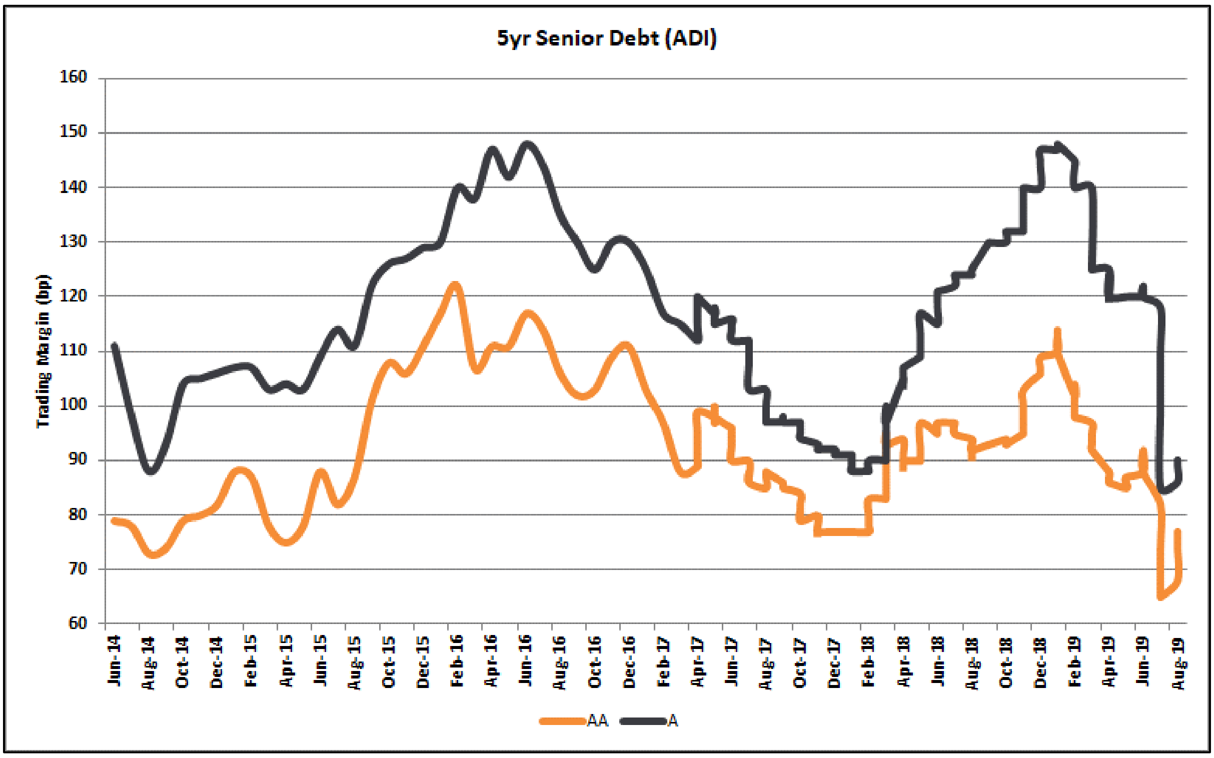
Collectively over the month, the "A" rated cohort widened between 5-7bp over the month, following the broad widening in credit assets. At month-end, Suncorp (A+) printed $350m of a 1 year deal at +40bp, reflecting the tight credit conditions.

There was also activity in the "BBB" rated regional bank space, with a new 5 year 'benchmark' issue launched by Bendigo-Adelaide Bank (BBB+) at +97bp, printing $500m, which was below their initial target size of $750m. For the month, the "BBB" rated sector widened by around 15bp at the 3 year part of the curve.

Overall, credit remains tight on a historical basis, reaching their levels last experienced approximately 4 years ago. With a further rate cut priced in over coming months, any medium-longer-dated fixed deposits offered above +100bp should be considered. 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)	31/08/2019	31/07/2019
"AA" rated – 5yrs	+77bp	+65bp
"AA" rated – 3yrs	+57bp	+45bp
"A" rated – 5yrs	+90bp	+85bp
"A" rated – 3yrs	+72bp	+65bp
"BBB" rated – 3yrs	+97bp	+82bp

Source: IBS Capital



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 2022 for the "AA" rated ADIs (domestic major banks)**;
- On or before 2020 for the "A" rated ADIs; and
- Within 12 months for the "BBB" rated ADIs (consider case by case).

Investors holding onto the above senior FRNs ('benchmark' issues only) in their last 1-2 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.

Council FRNs – Sale/Switch Recommendations

At the next best opportunity, we would recommend Council switching out of the following FRN given it is now yielding a low rate to maturity:

- $2.00m Newcastle PBS (BBB) FRN maturing 07/04/2020 (ISIN: AU3FN0026969). Trading margin around **+54bp** or capital price ~$100.47 (capital gain ~**$9,400**).

We can provide a switch recommendation into a new issue when it is advantageous to do so. Council also has the option to redeem this FRN and realise a profit should funds be required at short notice.

Economic Commentary

International Market

Volatility returned to global financial markets over August as **recessionary fears, political instability and the ongoing trade wars drove sentiment. The US and UK 2yr/10yr yield curve spreads inverted for the first time since 2007** and the 30-year US bond yield touched a record low at 1.94%. Inversion in the 2/10s spread has preceded each of the last five US recessions.

Global equity markets finally parred back some of their gains in August. **In the US, the S&P 500 Index fell -1.81%**, while the NASDAQ dropped -2.60**%**. Across Europe, the main economies also fell, led by UK's FTSE Index (-5.00%), Germany's DAX (-2.05%) and France's CAC (-0.70%).

Trade tensions escalated after US President Trump announced tariffs could go **"*well beyond*" 25%**. **China then announced it would impose new tariffs on $75 billion worth of US goods**. The retaliatory tariffs came after Trump surprisingly ended a trade war cease-fire by threatening to impose 10% tariffs on another $300 billion of Chinese goods.

US CPI printed higher than expected in July with core inflation at +0.3% m/m against +0.2% expected. The US unemployment rate held steady at 3.7% in July (expectations of 3.6%), driven by higher participation to 63.0% from 62.9%.

Eurozone Q2 GDP came in at +0.2% for the quarter, with the annual rate down to +1.1% from +1.2%. Headline CPI fell to +1.1% from +1.3%, while core CPI fell to +0.9% from +1.1%.

The Bank of England (BoE) kept rates unchanged at 0.75% but downgraded their growth forecasts to +1.3% in 2019 from +1.5%, and for 2020 to +1.3% from +1.6%. **The UK economy contracted by -0.2% over the June quarter**, with the annual rate dropping to +1.2% (from +1.8%). It was the first quarterly decline since 2012 and before then the GFC.

The UK plunged closer to a constitutional crisis after PM Johnson suspended parliament for five weeks starting from September 12-14 to October 14, in lead up to the October 31 Brexit date.

The 66th Italian government collapsed during the month, following an attack by independent MP Giuseppe Conte on coalition partner Matteo Salvini, the deputy PM and leader of the far-right, anti-immigration League party.

The RBNZ cut interest rates by 50bp to 1% rather than the anticipated 25bp movement. This was then followed by an easing by India of 35bp and Thailand by 25bp.

Chinese profits kept alive global growth fears with Industrial Profits -3.1% y/y, well down from the previous month's +1.1% y/y. China's annual industrial production growth came in at 4.8%, down from 6.3% in June, which was a mere 0.2% seasonally adjusted monthly rise, the weakest since mid-2015.

IMPERIUM MARKETS

The MSCI World ex-AUS fell -2.17% for the month of August.

Index	1m	3m	1yr	3yr	5yr	10yr
S&P 500 Index	-1.81%	+6.84%	+0.86%	+10.47%	+7.87%	+11.11%
MSCI World ex-AUS	-2.17%	+4.61%	-1.67%	+7.66%	+4.34%	+7.19%
S&P ASX 200 Accum. Index	-2.36%	+4.23%	+9.04%	+11.38%	+7.90%	+8.61%

Source: S&P, MSCI

Domestic Market

After two successive rate cuts, the RBA kept interest rates unchanged at 1.00% in its meeting in August. The Board remains on an explicit easing bias, noting they "*will continue to monitor developments in the labour market closely and **ease** monetary policy further if needed*" (previously "*adjust monetary policy if needed*"). The RBA remains cautiously optimistic about growth and now thinks it will take longer to return to their 2-3% inflationary target band (forecasted to return in 2021).

Governor Lowe commented on the headwinds of mounting political uncertainty saying, "*we are experiencing a period of major political shocks*" citing developments in the US, Brexit, Hong Kong, Italy and elsewhere, suggesting "*political shocks are turning into economic shocks*".

The CPI rose by +0.6% in Q2 after holding steady in Q1. Annual inflation picked up from +1.3% to +1.6%. **The trimmed mean CPI, which is the RBA's preferred measure of underlying inflation, rose by +0.4% in Q2 after a +0.3% rise in Q1. Annual core inflation was unchanged at +1.6%**, marginally above the multi-decade low of +1.5% reached in 2016.

The trade surplus rose to a new record $8.0bn in June, exceed expectations of $6.0bn. Exports rose 1% on increased sales of bulk commodities, while imports declined 4%, suggesting domestic demand remains weak.

The wage price index rose by +0.6% in Q2 after a +0.5% increase in Q1, with annual growth unchanged at +2.3%. The rise matched the RBA's recently-downgraded forecast. Quarterly growth has ranged between +0.5 and +0.6% for almost three years now, suggesting annualised growth remains stuck at a low +2¼%.

The unemployment rate came in at 5.2% in July, unchanged for the fourth consecutive month as employment grew by a much stronger-than-expected +41k. While the ongoing strength in employment will be reassuring for the RBA, these data suggest that spare capacity remains in the labour market given the RBA estimates the NAIRU at 4.5%. Meanwhile the **underemployment rate ticked up +0.2% to 8.4%** as more part-time workers wanted longer hours of work.

There were more signs of stabilisation in the domestic housing market with the preliminary auction clearance rate at its highest level in over two years at 76.6%.

The Australian dollar slid another -2½% this month, reaching multi-year lows, finishing at US67.18 cents (from US68.94 cents the previous month).

Credit Market

The main global credit indices marginally tightened over August despite the 'risk-off' environment. Credit spreads remain very tight on a historical basis (trading around early 2018 levels):

Index	August 2019	July 2019
CDX North American 5yr CDS	54bp	55bp
iTraxx Europe 5yr CDS	49bp	50bp
iTraxx Australia 5yr CDS	64bp	59bp

Source: Markit

Fixed Interest Review

Benchmark Index Returns

Index	August 2019	July 2019
Bloomberg AusBond Bank Bill Index (0+YR)	+0.08%	+0.12%
Bloomberg AusBond Composite Bond Index (0+YR)	+1.51%	+0.95%
Bloomberg AusBond Credit FRN Index (0+YR)	-0.04%	+0.46%
Bloomberg AusBond Credit Index (0+YR)	+0.87%	+1.02%
Bloomberg AusBond Treasury Index (0+YR)	+1.95%	+0.96%
Bloomberg AusBond Inflation Gov't Index (0+YR)	+0.56%	+1.55%

Source: Bloomberg

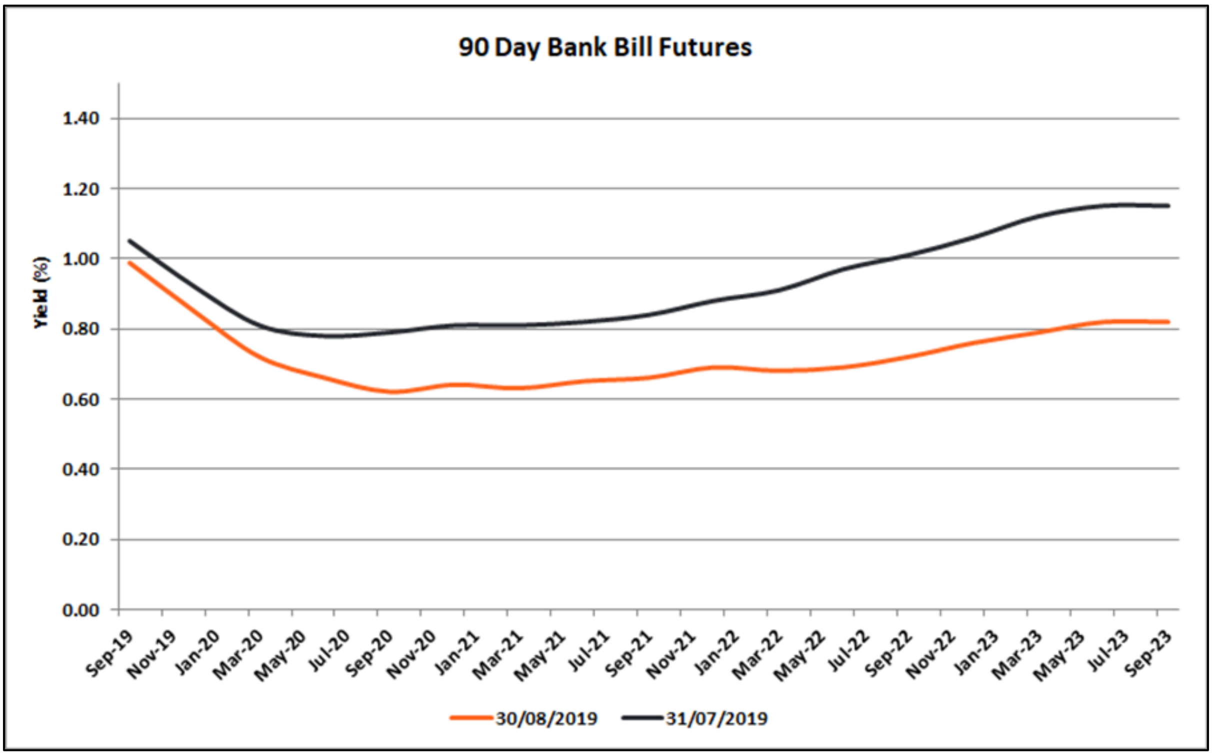
Other Key Rates

Index	August 2019	July 2019
RBA Official Cash Rate	1.00%	1.00%
90 Day (3 month) BBSW Rate	0.97%	1.01%
3yr Australian Government Bonds	0.67%	0.81%
10yr Australian Government Bonds	0.89%	1.19%
US Fed Funds Rate	2.00%-2.25%	2.00%-2.25%
10yr US Treasury Bonds	1.50%	2.02%

Source: RBA, AFMA, US Department of Treasury

<u>***90 Day Bill Futures***</u>

Over August, bill futures fell across the curve on pricing expectations of further rate cuts, particularly after RBA Governor Lowe commented to expect an "*extended period*" of low interest rates and discussed the (for now, unlikely) possibility of quantitative easing (QE) in Australia. **At month-end, the futures market was fully pricing in the next 25bp rate cut by November 2019, and a further 25bp cut by May-2020, which would take the official cash rate down to 0.50%.**



Source: ASX

Fixed Interest Outlook

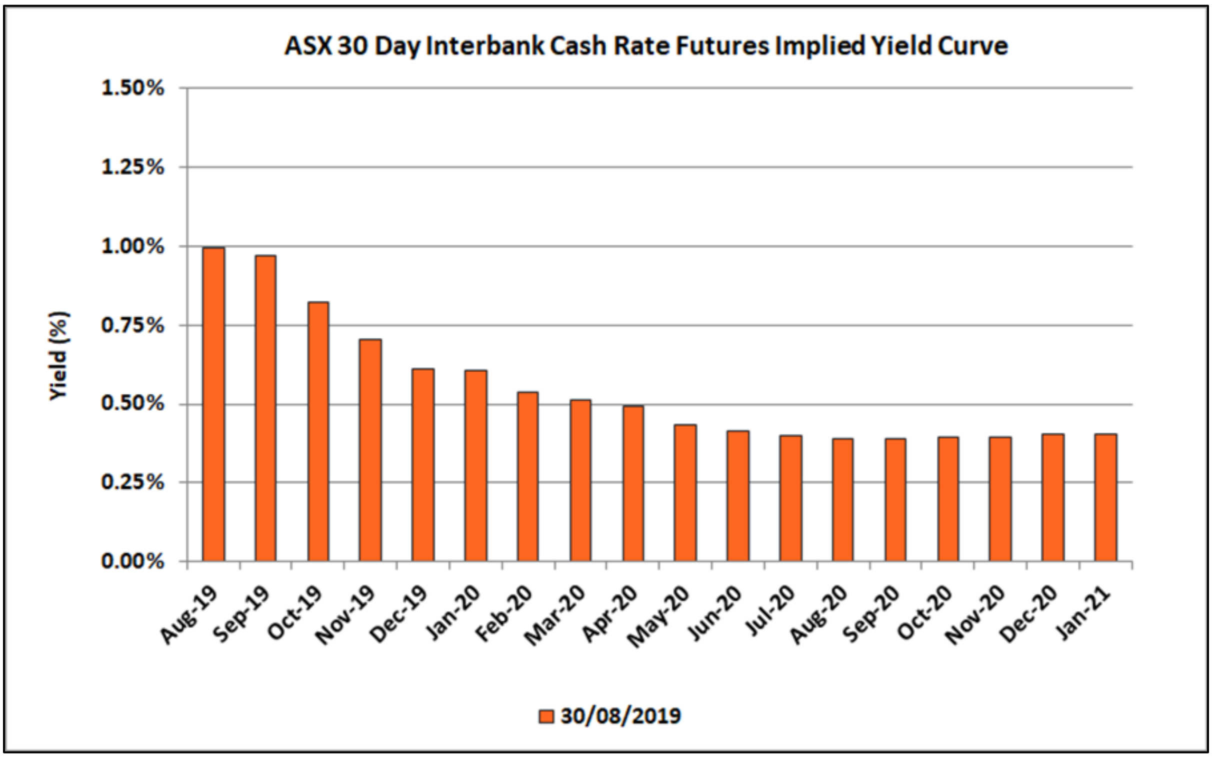
With global inflation remaining low and downside risks for global growth increasing (driven by the ongoing trade wars and geopolitics), most global central banks have moved towards an easing bias. After the US Fed cut rates on 31st July, the market is currently fully factoring in the next 25bp rate cut on 18th September and a further cut by the end of 2019.

Domestically, the RBA remains on an easing bias looking to address the 'spare capacity' in the economy. The RBA has suggested that additional stimulus through further rate cuts may be warranted in order to target full employment. Governor Lowe is looking for support from the Federal Government through expansionary fiscal policy, discussed the idea of Quantitative Easing (QE), and has now flagged an ***"extended period"*** **of low interest rates to achieve full employment and progress towards their inflation target**.

The global key risks for the RBA stem from the impact of ongoing trade and technology disputes, softening inflation, political uncertainty (e.g. US, Brexit, Hong Kong, Italy) and a broader slowdown in the global economy. The Board will continue to assess developments in the global and domestic market before considering further rate cuts.

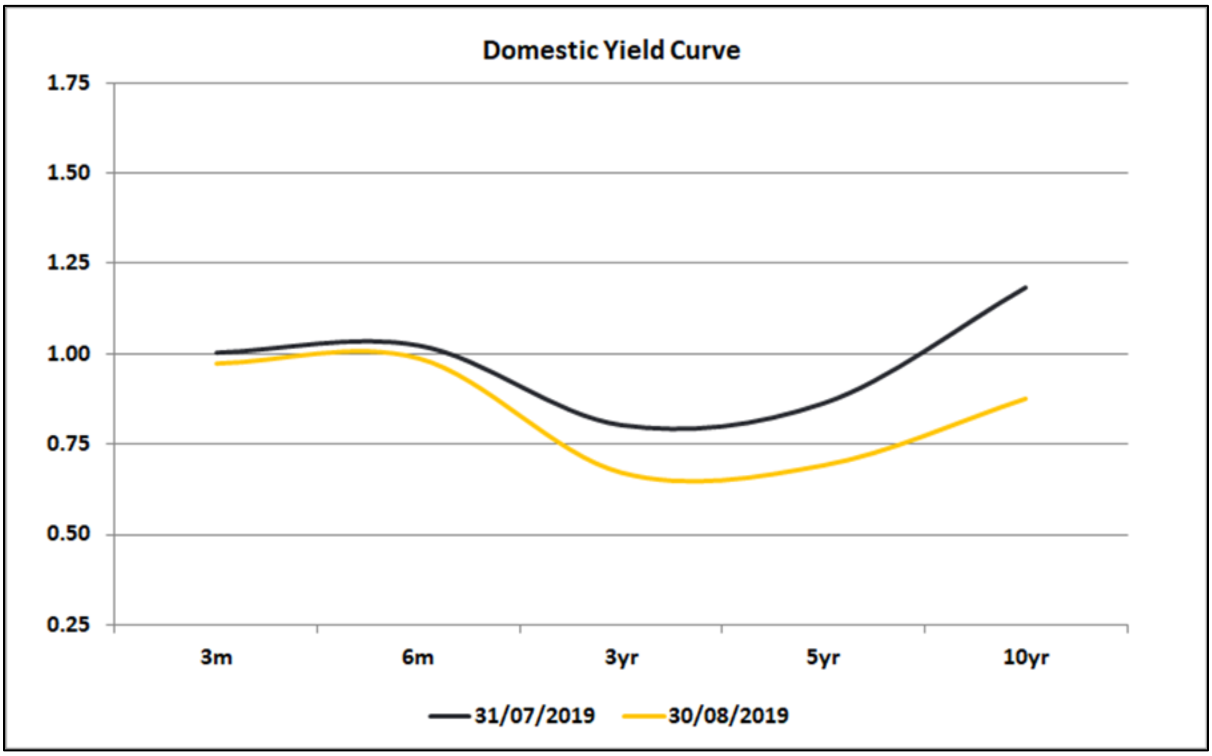
Domestically, they are focused on employment, inflation, wage growth, housing and consumption. Should these areas continue to show signs of softening, **the RBA remains on hand to adjust the official cash rate lower if required**.

<u>The futures market currently prices in a further 25bp rate cut by November 2019, taking the official cash rate down to 0.75%, with another factored in by May 2020</u>:



Source: ASX

Over the longer-term, the domestic bond market continues to suggest a 'lower-for-longer' period of interest rates. Over the month, yields fell up to -30bp at the longer end of the curve:



Source: AFMA, ASX, RBA