8.3. Investments and Loan Borrowings Held as at 30 September 2020

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ATTACHMENTS:
1. Monthly Investment Report - September 2020 [**8.3.1** - 19 pages]

PURPOSE:

This report provides details of the performance of Council's investment portfolio and borrowing limits for the period ending 30 September 2020.

EXECUTIVE SUMMARY:

Investment Portfolio:
The Investment portfolio (cash and investments) held as at 30 September 2020 had a market value of $102.5 million, with an annualised return of 2.01% for the year to date,1.43% above the reportable BBSW Bank Bill Index of 0.58%. The portfolio value increased during September by $9.6 million which was mainly attributed to the receipt of rate instalment revenues.

The actual investment returns for the year to date as at 30 September 2020 were $353,333 which was approximately 20% less than the year to date budgeted estimate. During the month, only 1 term deposit matured. These funds will be re-invested at the current interest rate (official cash rate is 0.25%) which will further reduce the performance of the portfolio. Council will see a decline in interest income over the next 12 months and through to such time when interest rates increase.

The COVID-19 pandemic has impacted Council's financial position and subsequently the funds available to invest. Council's user charges and fees have been adversely affected with the imposed restrictions in addition to reductions in revenues associated with parking and community facilities. It is anticipated that revenues will continue to improve, and this will be reflected in the amount of funds invested.

Borrowings:
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 30 September 2020 is $7,891,956.69.

FINANCIAL IMPLICATIONS:

The 2020/21 budgeted returns on investments is estimated to be $1,350,000.00. The estimate will be reviewed and reported in the December Budget Review which will identify any changes to the current projections. The investment portfolio is managed to ensure liquidity to meet operational requirements.

Any surplus funds generated in excess of the adopted estimates will be transferred to Council's internally restricted reserves.

RECOMMENDATION:

1. THAT the report on Investments and Loan Borrowings held as at 30 September 2020 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

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 September 2020 and annualised for the year to date as at 30 September 2020 (including investments which have matured prior to 30 September 2020).

	September 2020	**Annualised YTD as at 30 September 2020**
Actual Return	0.14%	2.01%
Benchmark	0.01%	0.58%
Variance	0.13%	1.43%

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.

Asset Type	Market Value as at 30 September 2020	Portfolio Breakdown as at 30 September 2020
Cash	$26,525,837.35	25.87%
Term Deposits	$68,000,000.00	66.32%
Floating Rate Notes (FRN's)	$8,011,066.10	7.81%
	$102,536,903.45	**100.00%**

During the month, only 1 term deposit matured that was invested 3 years ago at considerably higher interest rates. The re-investment of these funds at lower rates will have an impact on future interest earnings. Council's average duration of term deposits is approximately 467 days, thus reducing the exposure to declining interest rates experienced with investment renewals.

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 30 September 2020 have been reviewed and are $84,943.00 less than the revised budget.

Summary of Returns from Investments:

Year	Original Annual Budget	Revised Annual Budget	YTD Budget (September)	YTD/Annual Actual (September)	YTD Budget to Actual Variance (September)
2020/21	**$1,350,000**	**$1,350,000**	**$438,276**	**$353,333**	**-$84,943**
2019/20	$1,500,000	$1,529,055		$1,896,660	$367,605
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

Year	Original Annual Budget	Revised Annual Budget	YTD Budget (September)	YTD/Annual Actual (September)	YTD Budget to Actual Variance (September)
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

The negative YTD budget to actual variance is directly attributed to the extension provided for rates payments as the phased budget for investment returns was prepared based on the cashflow that typically would be available in September.

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 Policy Holding	Distribution as at 30 September 2020
AA Category	100.00%	53.10%
A Category	60.00%	15.86%
BBB Category	35.00%	30.07%
Unrated ADIs (NR)	10.00%	0.98%

As at the end of September, all categories were within the Policy limits.

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
31/10/2019	$8,510,235.19	$88,271.22	$201,368.32	$ 289,639.54
31/01/2020	$8,306,826.48	$86,230.83	$203,408.71	$289,639.54
30/04/2020	$8,099,526.94	$82,340.00	$207,299.54	$289,639.54
31/07/2020	$7,891,956.69	$82,069.29	$207,570.25	$289,639.54

The next loan instalment is due on 31 October 2020.

Loan Funded Capital Projects as at 30 September 2020:

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

September 2020

IMPERIUM MARKETS

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Impact of COVID-19 to Council's Portfolio

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

With regards to financial markets, of importance was the RBA cutting interest rates twice in March 2020, taking the official cash rate down to a record low of 0.25%. Shares (equities) experienced a significant correction in March but recovered substantially due to the unprecedented fiscal and monetary policy support from global central banks and governments. Risk markets suffered another selloff in September as investors remained nervous after the surge in virus infections in the US and Europe and the lack of clarity with regards to the timing of additional fiscal stimulus measures in the US.

With regards to the medium-longer term outlook for financial markets, of importance is the RBA's outlook and stance on the current situation:

1. The RBA's official cash rate will remain unchanged at its emergency level of 0.25% until its objectives of full employment and inflation are reached;
2. The extension of the Term Funding Facility (TFF) until 30 June 2021, allowing all ADIs to access cheap funding directly from the RBA at a cost of 0.25% for 3 years (the facility was increased from an original $90bn to $200bn);
3. RBA Governor Lowe has commented that he has not seen any signs of stress in the financial system from this crisis because unlike the GFC, the banks have cash and are well capitalised. He also suggested that Australia had "*fantastic fundamentals*" and had so far been effective at containing the virus and providing policy stimulus;
4. The RBA Board expects rates would be low "*for a very long period of time*" and has recently suggested **they could ease policy further by cutting the cash rate, 3-year yield target and TFF rate by 15bp to 0.10% (from 0.25%)**.

The biggest impact to Council's investment portfolio is with regards to its largest exposure being assets held in bank term deposits, which accounts for around ~66% of Council's total investment. The biggest risk that Council faces over the medium-longer term in this environment is not the potential loss of capital (given all the banks are well capitalised and regulated by APRA), but the rapid loss of interest income as interest rates have plummeted.

Council's term deposit portfolio was yielding 1.64% p.a. at month-end, with a weighted average duration of around 467 days or ~1¼ years. **This average duration will provide some income protection against the low interest rate environment over the next 12 months**. As existing deposits mature however, they will inevitably be reinvested at much lower prevailing rates.

Given official rates have fallen to record lows, Council is likely to see a rapid decline in interest income over future financial years. Its budgeted income over the medium-longer term needs to be revised to reflect the low interest rate environment. Returns between 0.60%-0.90% p.a. may potentially be the "norm" over the next few financial years.

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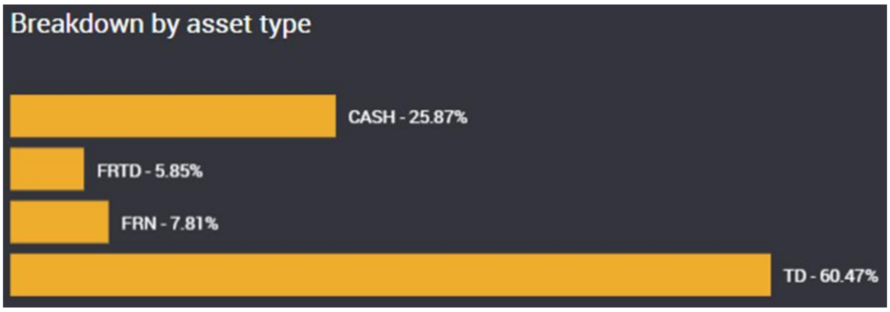
Council's Portfolio & Compliance

Asset Allocation

As at the end of September 2020, the portfolio was mainly directed to fixed and floating rate term deposits (66.32%). The remaining portfolio is directed to FRNs (7.81%) and overnight cash accounts (25.87%).

We would consider increasing the allocation to liquid senior floating rate notes (FRNs), if there are any remaining attractive securities in the primary or secondary market. This will not only offer additional upside with regards to the portfolio's investment returns, but also provide additional liquidity (FRNs are saleable – generally accessible within 2 business days). FRNs are also dominated by the higher rated ADIs which allows Council to maintain a bias towards the higher rated banks.

With the RBA flagging the possibility of a further interest rate cut, the priority should be to lock in any attractive medium-longer dated fixed deposits that may still be available to address reinvestment risk.



Term to Maturity

Overall, the portfolio remains lightly diversified from a maturity perspective. The 3-12 month duration is slightly below minimum limit, but this is more than offset by the high allocation in the 0-3 month allocation. Around 11½% of assets directed to medium-term assets (2-5 years). There is still high capacity to invest in the medium-term horizon, with approximately $39m at month-end.

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 fixed term deposits to address reinvestment risk.

Compliant	Horizon	Invested ($)	Invested (%)	Min. Limit (%)	Max. Limit (%)	Available ($)
✓	0 - 90 days	$37,525,837	36.60%	10%	100%	$65,011,066
X	91 - 365 days	$12,000,000	**11.70%**	20%	100%	$90,536,903
✓	1 - 2 years	$41,257,195	40.24%	0%	70%	$30,518,637
✓	2 - 5 years	$11,753,871	11.46%	0%	50%	$39,514,581
✓	5 - 10 years	$0	0.00%	0%	25%	$25,634,226
		$102,536,903	**100.00%**			

Counterparty

As at the end of September, Council did not have an overweight position to any single ADI. Overall, the portfolio is well diversified across the entire credit spectrum, including some exposure to the unrated ADIs.

Compliant	Issuer	Rating	Invested ($)	Invested (%)	Max. Limit (%)	Available ($)
✓	CBA (BankWest)	AA-	$28,415,351	27.71%	30.00%	$2,345,720
✓	NAB	AA-	$9,033,530	8.81%	30.00%	$21,727,541
✓	Westpac	AA-	$17,000,000	16.58%	30.00%	$13,761,071
✓	Suncorp	A+	$1,257,368	1.23%	15.00%	$14,123,168
✓	ING Bank	A	$15,000,000	14.63%	15.00%	$380,536
✓	BOQ	BBB+	$10,000,000	9.75%	10.00%	$253,690
✓	AMP Bank	BBB	$3,157,746	3.08%	10.00%	$7,095,944
✓	Auswide Bank	BBB	$10,000,000	9.75%	10.00%	$253,690
✓	Beyond (Nexus)	BBB	$3,000,000	2.93%	10.00%	$7,253,690
✓	ME Bank	BBB	$3,257,195	3.18%	10.00%	$6,996,495
✓	Newcastle PBS	BBB	$1,415,714	1.38%	10.00%	$8,837,977
✓	WAW CU	Unrated	$1,000,000	0.98%	5.00%	$4,126,845
			$102,536,903	**100.00%**		

During September 2020, ratings agency **S&P downgraded AMP Bank by one notch to "BBB"** stating its view that "*the overall creditworthiness of the AMP group is weaker*" and that "*the group is exposed to challenges that may disrupt its overall strategic direction and its ability to effectively execute its strategy.*" We have no issues with Council's investments with AMP Bank, given they are super-senior ranked assets, extremely low risk and high up the bank capital structure.

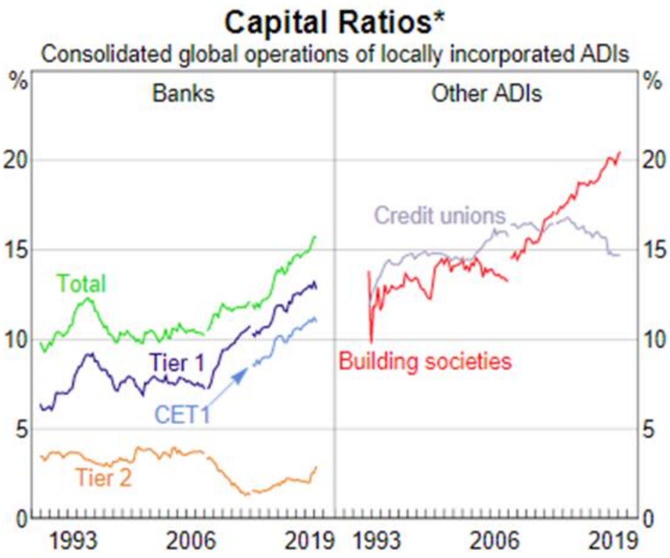
We remain supportive of the regional and unrated ADI sector (and have been even throughout the GFC period). They continue to remain solid, incorporate strong balance sheets, while exhibiting high levels of capital – typically, much higher compared to the higher rated ADIs. Some unrated ADIs have up to 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. ***RBA Governor Lowe has recently commented that they have not seen any signs of stress in the financial system and that unlike during the GFC, the banks now have cash, are well capitalised and are acting as "shock absorbers" in the current crisis***.

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. **APRA's mandate is to "*protect depositors*" and provide "*financial stability*".**

The biggest single risk that depositors face in the current low interest rate environment is not capital or credit risk, but reinvestment risk. Interest rates are now at their effective lower bound of 0.25% and could potentially drop to 0.10% if economic conditions deteriorate further.



* 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

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Credit Quality

The portfolio remains well diversified from a credit ratings perspective. As at the end of September 2020, all categories were 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	$54,448,881	53.10%	100%	$48,088,022
✓	A Category	$16,257,368	15.86%	60%	$45,264,775
✓	BBB Category	$30,830,655	30.07%	35%	$5,057,261
✓	Unrated ADIs	$1,000,000	0.98%	10%	$9,253,690
		$102,536,903	**100.00%**		

Performance

Council's performance for the month ending 30 September 2020 is summarised as follows:

Performance	1 month	3 months	6 months	FYTD	1 year
Official Cash Rate	0.02%	0.06%	0.13%	0.06%	0.46%
AusBond Bank Bill Index	0.01%	0.03%	0.09%	0.03%	0.58%
Council's T/D Portfolio	0.14%	0.46%	0.96%	0.46%	2.03%
Council's FRN Portfolio	0.09%	0.33%	0.94%	0.33%	1.93%
Council's Portfolio^	**0.14%**	**0.45%**	**0.96%**	**0.45%**	**2.01%**
Outperformance	**0.13%**	**0.42%**	**0.87%**	**0.42%**	**1.43%**

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

For the month of September, the total investment portfolio (excluding cash) provided a strong return of +0.14% (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.

We note most 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's performance has narrowed the gap compared to term deposits, although this is likely to reverse following the multiple interest rate cuts over the past year.

Over the past year, the total portfolio (excluding cash) returned an outstanding +2.01% p.a., outperforming bank bills by 1.43% 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 2020 Council Rankings). 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 25 individual deposits North Sydney Council held, 10 are still yielding higher than 1.75% p.a. That is, around 40% of the outstanding deposits held are currently earning more than the highest rate available in the market from any rated bank out to 5 years.

Council's Term Deposit Portfolio & Recommendation

As at the end of September 2020, Council's deposit portfolio was yielding an **attractive 1.64% p.a.** (down 4bp from the previous month), with an average duration of around 467 days (~1¼ years). We recommend Council maintains or even 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 historical low levels of 0.25%.

As the past decade has highlighted (post-GFC era), 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 overpaid for liquidity and 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**.

At the time of writing, we see value in:

ADI	LT Credit Rating	Term	T/D Rate
ICBC, Sydney	A	5 years	1.20% p.a.
BoQ	BBB+	5 years	1.15% p.a.
ICBC, Sydney	A	4 years	1.05% p.a.
BoQ	BBB+	4 years	1.05% p.a.
BoQ	BBB+	3 years	0.95% p.a.
BoQ	BBB+	2 years	0.90% p.a.
ICBC, Sydney	A	3 years	0.90% p.a.
MyState	BBB	2 years	0.85% p.a.
ICBC, Sydney	A	2 years	0.82% 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.

For terms under 12 months, we believe the strongest value is currently being offered by the regional ADIs (dependent on daily funding requirements):

ADI	LT Credit Rating	Term	T/D Rate
AMP	BBB	12 months	^0.80% p.a.
MyState	BBB	12 months	0.80% p.a.
AMP	BBB	6-11 months	^0.75% p.a.
BoQ	BBB+	9-12 months	0.70% p.a.
BoQ	BBB+	6 months	0.65% 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
ICBC, Sydney	A	12 months	~0.75% p.a.
CBA	AA-	12 months	~0.70% p.a.
NAB	AA-	12 months	0.65% p.a.
Westpac	AA-	12 months	~0.65% p.a.
NAB	AA-	3-11 months	0.60% p.a.

Senior FRNs & Recommendations

Over September, amongst the senior major bank FRNs, physical credit securities widened between 4-7bp at the loner-end of the curve in the 'risk-off' environment. Bid-ask spreads have normalised to pre-COVID levels on the back of excess liquidity and short supply. 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 in subsequent years.

A new 5 year senior major bank FRN would now be issued around +62bp, appearing relatively expensive. We expect minimal primary issuance from the domestic banks in the immediate future given the RBA's $200bn term funding facility (TFF) to the ADIs, offering a rate of 0.25% (which might be reduced to 0.10% in coming weeks) for 3 years, and has now been extended to June 2021. The lack of supply from new (primary) issuances has played a major role with the rally in credit markets since the selloff experienced earlier this year.

Amongst the "A" and "BBB" rated sector, the senior securities were marked around 3-5bp wider over September. During the month, Bank of Communications, Sydney Branch (A-) issued a new 3 year senior FRN deal at +83bp, initially tightening from price guidance of +88bp, printing $500m. We thought this was issued at a fair value and relatively attractive in this environment.

While turnover in the secondary market is still predominately dominated by the major banks, given the lack of supply, we have started to observe that even a handful of regional bank senior paper has sometimes been trading inside "mid" levels over recent months.

Credit margins are now trading very tight on a historical level and look fairly expensive. 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)	30/09/2020	31/08/2020
"AA" rated – 5yrs	+62bp	+55bp
"AA" rated – 3yrs	+38bp	+34bp
"A" rated – 5yrs	+80bp	+75bp
"A" rated – 3yrs	+55bp	+50bp
"BBB" rated – 3yrs	+83bp	+80bp

Source: IBS Capital

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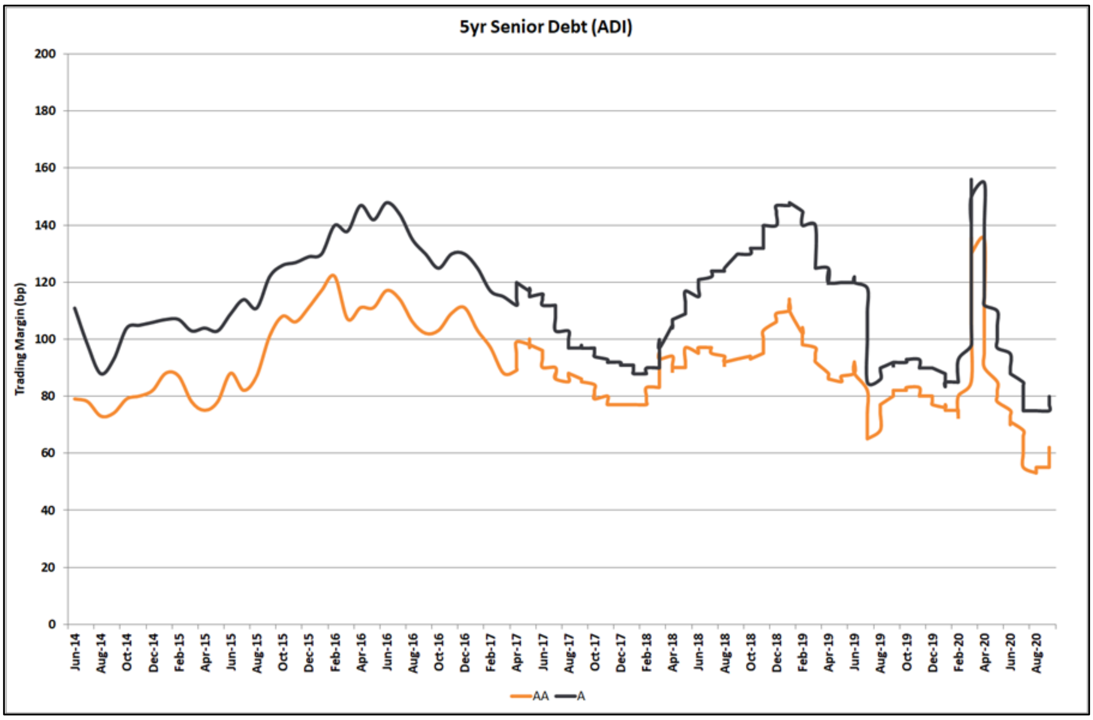


Source: IBS Capital

We now generally **recommend switches** ('benchmark' issues only) into new attractive primary issues (or longer-dated alternatives), out of the following senior FRNs that are maturing:

- **On or before 2023 for the "AA" rated ADIs (domestic major banks)**;
- On or before mid-2021 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's Senior FRNs Sale/Switch Recommendations

In early 2021, we recommend Council switches out of the following FRN:

- $2.00m CBA (AA-) FRN maturing 11/01/2024 (ISIN: AU3FN0046561) – trading margin marked around **+40.0bp** or capital price of $102.36 (capital gain **~$47,000**).

The above sale would result in capital gains totalling ~**$47,000** and would most likely be switched into a higher yielding complying FRN or term deposit. At this stage, we prioritise switching into any remaining attractive medium-longer dated fixed deposit given the depressed state of interest rates.

Economic Commentary

International Market

Over September, risk sentiment rose as investors remained nervous following the surge in virus infections in the US and Europe.

The US Fed's decision to refrain from increasing its bond buying at the September FOMC meeting and the lack of clarity with regards to the timing of additional fiscal stimulus measures also disappointed some market participants.

In the US, **the S&P 500 fell -3.92%, while the NASDAQ lost -5.16%**. Across the main European markets, Germany's DAX fell -1.43%, UK's FTSE lost -1.63% and France's CAC by -2.91%.

The US Federal Reserve (Fed) now expects to hold rates until maximum employment conditions have been reached and **inflation was on track to "*moderately exceed 2% for some time*"**. It revised up its 2020 GDP forecast to a -4.0% / -3.0% range from -7.5% /-5.5%, but lower for 2021 and 2022.

The US unemployment rate dropped to 8.4% from 10.2%, well below the expected 9.8%. US core CPI for August came in at +0.4% m/m against +0.2% expected. The y/y figure has rose to +1.7%.

The ECB kept all its policy settings unchanged, including its deposit rate at -0.5% and its asset purchase programmes.

UK inflation for August printed lower, with headline CPI coming in at+0.2% y/y from +1.0% and core CPI falling to +0.9% y/y from +1.8%.

Bank of England (BoE) Governor Bailey downplayed the probability of negative rates ("*in the toolbag but it doesn't imply anything about the probability of us using negative interest rates at the moment*") and also added that technical preparations for negative rates would take time.

China's August trade balance was stronger than expected on a surge in exports (+9.5% y/y against 7.5% expected), while imports were weaker than expected (-2.1% y/y against expectations of +0.2%).

During the month, **New Zealand experienced its first trades at negative yields** for a nominal NZ government bond and swap rate.

The MSCI World ex-Aus Index fell -3.52% for the month of September:

Index	1m	3m	1yr	3yr	5yr	10yr
S&P 500 Index	-3.92%	+8.47%	+12.98%	+10.11%	+11.86%	+11.41%
MSCI World ex-AUS	-3.52%	+7.64%	+9.06%	+5.99%	+8.53%	+7.47%
S&P ASX 200 Accum. Index	-3.66%	-0.44%	-10.21%	+4.80%	+7.31%	+6.93%

Source: S&P, MSCI

Domestic Market

The RBA kept its cash target and 3-year yield target unchanged at 0.25% in its September meeting. The Board reiterated that neither will be increased/removed before there is progress toward the goals of full employment and the inflation target.

The RBA Minutes of the September Board meeting reinforced the RBA is still actively considering what else it could do. RBA Deputy Governor Debelle then signalled that there were "*possibilities for further monetary policy action should the Reserve Bank Board decide that is warranted*". **There are ongoing (downside) risks that the RBA will ease policy further by cutting the cash rate, 3-year yield target and TFF rate by 15bp to 0.10% (from 0.25%)**. The RBA may also announce outright quantitative easing (QE) purchases in the 5-10 year part of the curve.

Q2 GDP fell by -7%, following a contraction of -0.3% in Q1, confirming Australia's first recession since 1991. On an annual basis, GDP came in at -6.3% till the end of June 2020. The fall in activity was driven by a collapse in household consumption, where spending on services fell -18% amid the peak of the restrictions.

The unemployment rate fell to 6.8% in August (from 7.5% in July). Employment rose +111k against a consensus of -35k with strength in both full-time (+36.2k) and part-time (+74.8k). The fall in unemployment came despite a one-tenth rise in the participation rate to 64.8% from 64.7%.

Retail sales rose +3.2% in July, driven by sales of household goods.

The Prime Minister flagged a number of spending measures to be announced in the upcoming October 6 budget: (1) front loading of infrastructure spend, with states to receive up to $10bn for projects; (2) bringing forward phase two income tax cuts by one year to July 2021; and (3) an investment tax allowance to encourage business investment.

Victoria's daily infection rate substantially declined, allowing the state to move out of Stage 4 lockdowns late in the month.

The Australian dollar finished -3.4% lower at US71.08 cents (from US73.54 cents the previous month).

Credit Market

The main global credit indices were mixed over September, with spreads tightening in the US while widening in Europe and Australia. The indices now trade back to their levels from mid-2019:

Index	September 2020	August 2020
CDX North American 5yr CDS	59bp	65bp
iTraxx Europe 5yr CDS	59bp	54bp
iTraxx Australia 5yr CDS	76bp	64bp

Source: Markit

Fixed Interest Review

Benchmark Index Returns

Index	September 2020	August 2020
Bloomberg AusBond Bank Bill Index (0+YR)	+0.01%	+0.01%
Bloomberg AusBond Composite Bond Index (0+YR)	+1.08%	-0.42%
Bloomberg AusBond Credit FRN Index (0+YR)	+0.02%	+0.10%
Bloomberg AusBond Credit Index (0+YR)	+0.48%	+0.12%
Bloomberg AusBond Treasury Index (0+YR)	+1.28%	-0.81%
Bloomberg AusBond Inflation Gov't Index (0+YR)	+1.39%	-1.01%

Source: Bloomberg

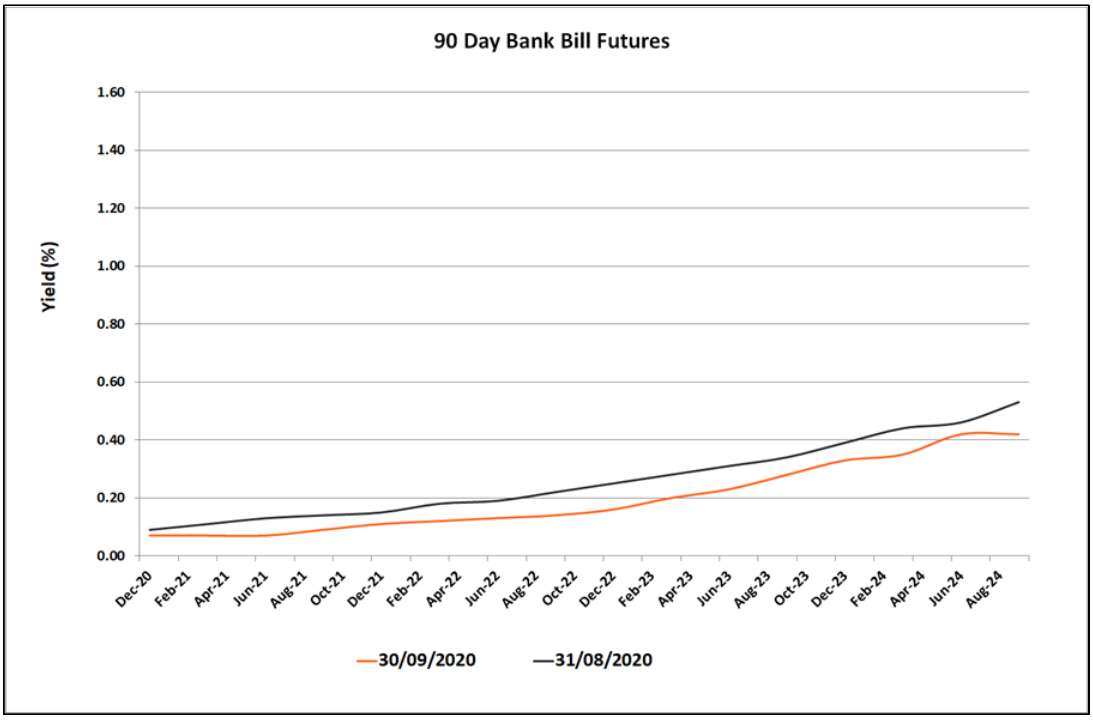
Other Key Rates

Index	September 2020	August 2020
RBA Official Cash Rate	0.25%	0.25%
90 Day (3 month) BBSW Rate	0.09%	0.09%
3yr Australian Government Bonds	0.17%	0.28%
10yr Australian Government Bonds	0.84%	0.98%
US Fed Funds Rate	0.00%-0.25%	0.00%-0.25%
10yr US Treasury Bonds	0.69%	0.72%

Source: RBA, AFMA, US Department of Treasury

90 Day Bill Futures

Over September, bill futures remained fell across the board after the RBA signalled it was considering further monetary easing. This includes cutting the official cash rate, 3 year target yield and the Term Funding Facility (TFF) to 10bp (from 25bp) and potentially quantitative easing (QE) targeted at longer-dated yields.



Source: ASX

Fixed Interest Outlook

There is growing pressure for policymakers to provide additional fiscal support to revive the global economic recovery. Ongoing hopes of an imminent vaccine have provided a safety net for risk markets.

The US Fed has reiterated it is committed to "*using its full range of tools to support the US economy*" and has signalled it is not considering raising interest rates at least until the end of 2023, as highlighted by its latest 'dot plots'.

The futures market pushed back expectations of the next Fed rate hike after it recently announced it aims to achieve a "*moderately above 2% inflation for some time*". The futures market does however continue to price in the possibility that the US Fed may need to take rates into negative territory over the next 6 months (around 18% by end of March 2021, although the Fed officially remains adamant this is not required).

Domestically, the RBA has signalled it is considering further monetary policy easing. This includes cutting the official cash rate, 3 year target yield and the Term Funding Facility (TFF) to 0.10% (from 0.25%) and potentially quantitative easing (QE), targeted at longer-dated yields.

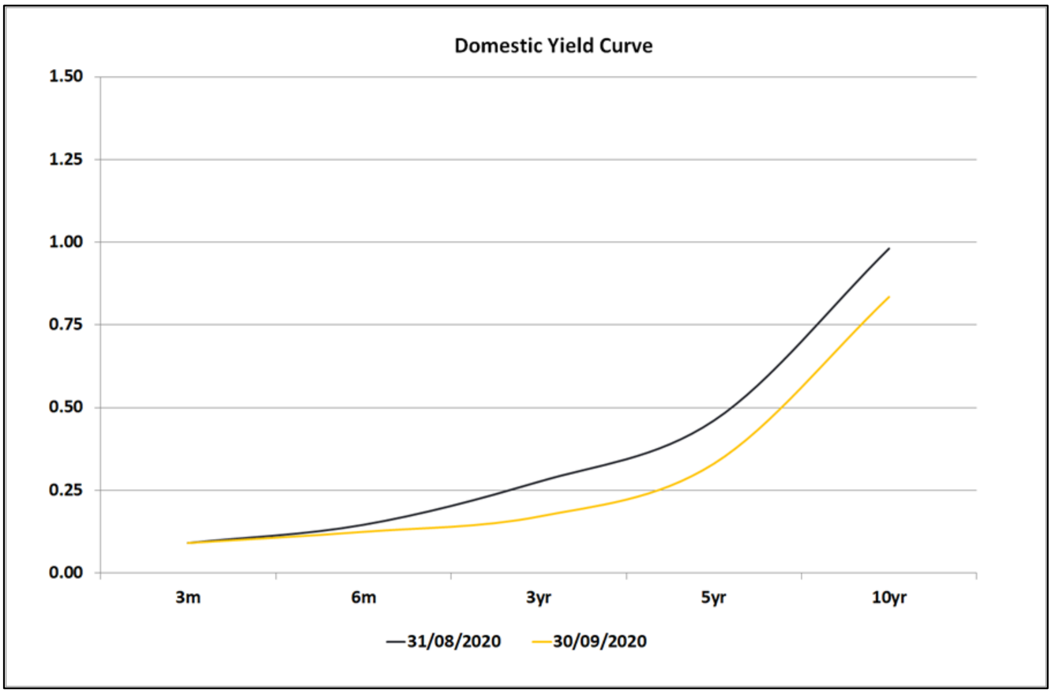
Their longer-term forward guidance is to keep committing the official cash rate unchanged (0.25%) or at the revised lower levels (potentially 0.10%) until there is a sustainable recovery and its economic objectives of full employment (unemployment rate of 4.5%-5.0%) and target inflation (2-3%) are on track.

Deputy RBA Governor Debelle has recently suggested that it would be **"*more than three years before sufficient progress was being made towards full employment to be confident that inflation will be sustainably within the target band*"** and that it is **"*highly unlikely that the cash rate will be raised over that time horizon*".**

RBA Governor Lowe has commented that unlike during GFC, **the banks have cash and are well capitalised**, and that they are **not seeing any signs of stress in the financial system**.

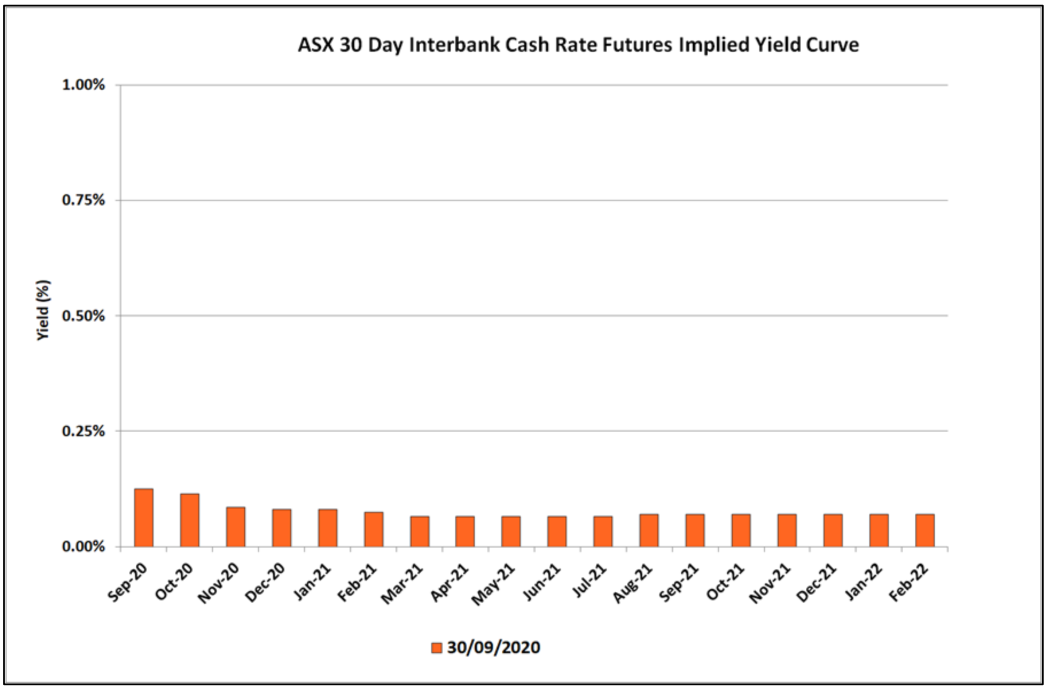
For now, the RBA is not contemplating adopting negative rates, indicating this would be "*extraordinarily unlikely*", citing the mixed empirical evidence on negative rates. In the short-term, it would be effective in lowering the exchange rate, but in the medium term, *"their effectiveness can wane including through the effect on the financial system. Negative rates can also encourage more saving*".

The domestic bond market continues to suggest a 'lower-for-longer' period of interest rates. Over the month, yields fell up to 15bp at the long-end, with 10-year government bond yields finishing at 0.84%:



Source: AFMA, ASX, RBA

The futures market is currently pricing around a 65% chance that the RBA will cut interest rates to 0.10% on the 6th October, while fully pricing in the 15bp cut by 3rd November:



Source: ASX

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