A Low Point in Central Banking

The market humiliated the RBA, breaking yield curve control in a day.

Background

In the depths of the COVID19 crisis, the RBA cut policy rate to around ¼%, and subsequently 0-10bp for various rates. BBSW traded around zero.

Having done so, **they looked around for ways to ease policy further**. Reluctant to employ the distortion of negative rates, how else might they express policy stimulus? They considered play books of the US Fed and the ECB from past and present crises. Measured included:

- Funding banks with concessional loans (in return for their concessions to borrowers)
- Quantitative easing – buying bonds
- Forward guidance – not only setting todays interest rate, but announcing it for years in advance to massage longer yields lower.

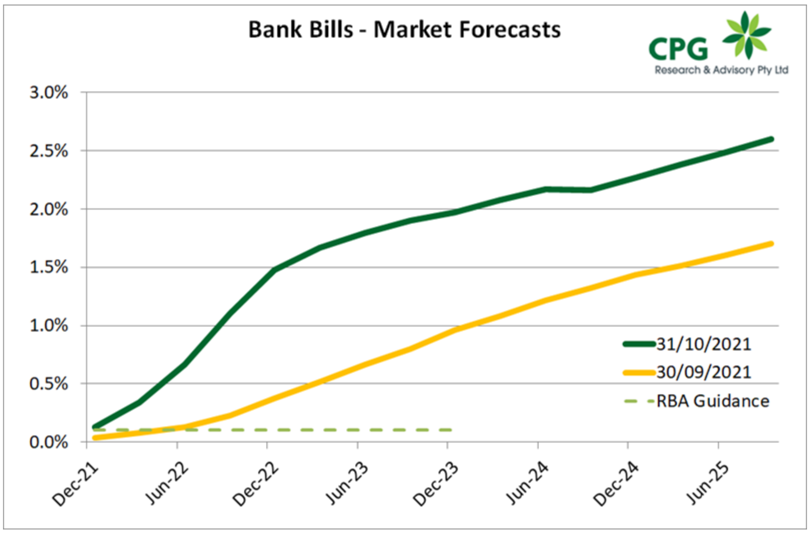
The next logical step: **If the yield curve can't be persuaded to match the guidance, controlling it.** The RBA set an official 3-year bond target of 0.1% - the first time since 1983 that they determined the price of bonds.

This is where the problems began.

2024

Having set a target for the 3-year bond, eventually this bond shorted to 2½ years. People asked, "*then what?*" **The RBA walked into the trap**, rolling their guidance and bond yield target out to April 2024. This is now well over 4 years from the start of the pandemic – too long to have confidence in the economic outlook. *What if there is recovery? What if there is an inflation shock?* This created a new round of speculation every 6 months.

Divergence



For some time, **the market has expected an early emergence** from zero interest rate policy. We have highlighted for months that the market does not believe the guidance, and probably should not believe the guidance.

This divergence between market implied pricing and RBA guidance worsened in the month.

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Arbitrage

If bills imply a 2% interest rate in early 2024, and the RBA is putting its money behind 0.1% guidance, this isn't just a theoretical curiosity. Real money is involved. Someone can sell bonds at 10bp (to the RBA, if necessary) and buy bill futures for the same exposure paying around 10x that, on average through the term. **Hedge funds can and almost certainly did make unlimited amounts of money doing this.**

In fact, the RBA could see the supply of bonds to purchase diminishing.

Some of these profits come from the RBA itself – overpaying for bonds when it could intervene in bills markets. The RBA is now nursing major capital losses on bonds it bought around 10bp, trading far out of the money.

(It doesn't actually matter, except to the pre-election budget if they need more capital.)

Capitulation

As the market challenged them to defend the 10bp target when bonds were trading at 50bp, **the RBA did nothing**. Not a dollar of purchases to defend their target.

At that point, investors knew yield curve control was finished. The RBA admitted it at the November meeting. They would have had to buy every single April 2024 bond!

So now everyone knows yield curve targeting is meaningless. RBA guidance is meaningless.

Anyone that bought bonds in reliance on this has now lost a point and a half of price – 15 years of yield at the prices paid way back in September!

Credibility, once lost, can take decades to regain for a central bank. Investors who made the mistake of listening to guidance will be very wary in future.

And another thing: A month after Evergrande dominated headlines, it has almost disappeared from commentary. 100k Google searches a day are down to 3k. They made two bond coupon payments, almost a month late, averting default until there is more clarity on how a bankruptcy would be managed.

The most systemically important Chinese bankruptcy until now was HNA, which owns Hainan Air and other critical assets.

We expect seniority of Evergrande claims will reflect how much the Chinese government cares about them:

1. Up to 1m **deposits by purchasers** for off-the-plan projects, which in many countries does not go into solicitors' escrow accounts but can be used by the builder to complete projects. These may be as much as half the total liabilities.
2. Bank-sold "wealth management products" held by retail investors
3. Liabilities to governments
4. Debts to Chinese banks
5. Debts to onshore (RMB) bondholders
6. Debts of offshore (USD, HKD) bondholders

The last group is effectively providing first-loss credit support, and bonds trading at 20% of par suggest that investors are largely resigned to their fate.

Leading Markets

Last month's loser are winners, and *vice versa*. The US Dow Jones, S&P500 and NASDAQ soared +5.9%, +7.0% and +7.3% respectively, all setting records. MSCI World ex-AUS jumped +5.6% in local terms.

Emerging Markets rose +1% in $US despite a severe fall in Brazil. Japan slid -3.4% ahead of its election with HK also down. Frontier gained +4%.

US 10-year bonds slipped to 1.56% (+4bp). High yield firmed to 308bp spread (-7bp), retesting post-GFC tights.

Other Highlights

COVID19 deaths passed 5m (+¼m) from almost 250m cases (+13m). The world reached 39% 2nd shot (+5%).

The G20 met ahead of Glasgow's COP26, with many 2050 net zero commitments.

The US Administration continued to fight for a scaled back "infrastructure" package.

US Q3 GDP's first estimate of 2% p.a. (0.5% QoQ) *vs* 6.7% in Q2 disappointed amid severe shipping interruptions.

US unemployment dived to 4.8% (-0.4%) in September, despite Non-farm Payrolls a modest +194k. Participation fell further to 61.6% (-0.1%). Youth unemployment fell to 9.0% (-0.9%).

Inflation rose to +5.4% YoY (+0.1%) after a +0.4% month *vs* +0.3%. Core inflation was unchanged at +4% . Retail sales rose +0.7%.

Eurozone unemployment eased to 7.5% (-0.1%) in September. Prices rose +0.8% in September and are +4.1% YoY (*vs* +3.4% to August). Core inflation reached +2.1%, not yet alarming given spikes in commodities and energy.

German bunds set at a 2-year high -10bp

UK bond yields also reached a post-COVID high of 1.22% with inflation 3.1% *vs* 3.2% in August, as the Bank of England prepares to raise rates from the current +0.1%. A +5.5% Q3 saw GDP +23% YoY.

Russian interest rates rose +75bp, now more than +300bp this cycle.

China's Evergrande delayed default and restructuring, making belated bond payments.

Domestic

ATAGI flagged a vaccine booster round after near completion of the primary rollout. At the original Oct 31st target date, 78% of 16+ year olds have 2 shots. Based on first doses, 2021 will see ~90%.

The RBA's *Minutes* said little, with the RBA apparently locked into current settings.

3-year bonds reached 1¼%, with even the 2-year closing at 67bp, up 50bp in two days and far above the RBA's 2024 target of 10bp. The RBA has completely lost yield curve control, and did not intervene.

Major bank paper continued to be sought after, issuing at tight spreads.

NSW' daily COVID counts fell below 200, with Victoria also declining – paradoxically while emerging from lockdown.

The month closed with ~78% of ages 16+ fully vaccinated, missing by just a day the original 80% (18+) target.

The ASX200 eased –0.1% but the Small Ordinaries rose +0.9%. CoreLogic reports +1.4% housing gains in October.

10-year bonds smashed through 2% before closing 1.95% (+46bp).

Prices rose +0.8% in Q3, to be +3% YoY. Core inflation is well contained at 2.1% YoY (after +0.7% in Q3), returning to the 2-3% target range after 6 years.

September unemployment rose to 4.6% (+0.1%) on 64.5% participation (-0.7%). Employment dived -138k (although fulltime rose +27k). Underemployment eased -0.1% to 9.2%. Youth unemployment rose to 10.8% (+0.2%).

August's $15.1bn trade surplus set a record on iron ore exports.

Retail trade rose +1.3% in September.

Commodities and Currency

WTI oil soared to a 7-year high $US83.57/bbl (+11%). Gold rose to $1783/oz (+1.8%). Iron ore fell –2.3% to $107/t. Coal closed at $223/t (+5.4%), with China intervening at a record $270.

Base metals Tin (+11%), Zinc (+12%), Copper (+7%) and Nickel (+9%) soared with Aluminium -5% against the trend.

The $A jumped to US75.25c (+4.4%), as the RBA tolerated higher market yields.

KEY FINANCIAL MARKET DATA – AS AT 31ST OCTOBER 2021 (UNLESS SPECIFIED)

Interest Rate Markets

Index Performance	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
Bloomberg AusBond Bank	0.00%	0.00%	0.01%	0.03%	0.27%	0.73%	1.17%

Key Rates	Oct-21	Sep-21	Aug-21
Australian Cash Rate	0.10%	0.10%	0.10%
90 day BBSW	0.07%	0.02%	0.01%
3 Yr Commonwealth Bonds	1.24%	0.32%	0.24%
10 Yr Commonwealth Bonds	1.95%	1.49%	1.16%
CDX North American 5 Yr CDS	52bp	54bp	46bp
iTraxx Europe 5 Yr CDS	51bp	51bp	45bp
iTraxx Australia 5 Yr CDS	65bp	70bp	58bp
US Fed Funds Rate	0-0.25%	0-0.25%	0-0.25%
US 10 Yr Bond Rate	1.55%	1.52%	1.30%

Equity Markets

Domestic	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
S&P/ASX 200 TR	-0.10%	0.51%	6.34%	27.96%	8.41%	11.92%	10.88%
S&P/ASX Small Ordinaries TR	0.92%	3.68%	7.88%	31.01%	13.08%	13.52%	11.45%
S&P/ASX 200 A-REIT TR	0.42%	4.38%	12.34%	30.87%	3.61%	9.87%	8.95%

International	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
US: S&P 500 ($US)	7.01%	5.13%	10.91%	42.91%	25.22%	21.48%	18.93%
US: NASDAQ ($US)	7.29%	5.79%	11.36%	42.99%	37.82%	29.67%	25.69%
MSCI World Acc. (Local Currency)	5.50%	4.33%	9.73%	40.44%	20.44%	17.73%	15.18%
MSCI World Acc. (AUD)	1.62%	1.58%	11.87%	31.29%	15.94%	15.94%	15.75%
FTSE 100 (£)	2.21%	4.14%	5.76%	34.52%	3.43%	4.43%	4.82%
MSCI Emerging Markets ($US)	0.99%	-0.49%	-4.87%	16.96%	12.52%	12.30%	9.39%

Fixed Interest Markets

Bonds	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
Bloomberg Global Agg TR AUD	-4.06%	-4.51%	1.74%	-7.67%	-2.18%	2.55%	2.79%
Bloomberg AusBond Composite	-3.55%	-4.93%	-2.33%	-5.30%	-0.76%	2.72%	2.58%
ICE BofA US High Yield TR USD	-0.18%	0.40%	2.43%	10.74%	6.56%	7.15%	6.25%

Data*	Current Period		Previous Period	
Employment Data				
Employment Growth	September	-138,000	August	-146,300
Unemployment Rate	September	4.60%	August	4.50%
Participation Rate	September	64.50%	August	65.20%
Lending Finance				
Housing Finance	September	-1.40%	August	-4.30%
Personal Finance	September	0.40%	August	-2.50%
Business Finance	September	13.00%	August	-26.40%
Other				
Balance on goods and services	August	15,077m	July	12,117m
Retail Sales	September	1.30%	August	-1.70%
Building Approvals	August	6.80%	July	-8.60%

*All data is seasonally-adjusted.

Median Fund Manager Returns (Morningstar)	1 month	3 month	6 month	1 year	2 year p.a.	3 year p.a.	5 year p.a.
Australian Equity Large Cap	-0.23%	1.95%	6.60%	30.67%	8.62%	11.00%	9.86%
Australian Equity Small Cap	1.03%	6.47%	10.64%	33.36%	16.35%	14.89%	11.57%
Global Equity Large Cap	0.64%	0.25%	8.51%	30.09%	14.30%	14.46%	14.63%
Global Equity Small Cap	-0.45%	-0.05%	6.62%	33.45%	17.45%	13.70%	12.67%
Australian Fixed Income	-3.58%	-5.02%	-2.40%	-5.23%	-0.68%	2.59%	2.38%
Global Fixed Income	-0.50%	-1.66%	0.07%	-1.23%	1.08%	3.85%	2.52%
Australian Listed Property	0.45%	4.77%	12.30%	31.36%	3.59%	9.39%	8.21%
Australian Cash	0.00%	0.00%	0.01%	0.05%	0.22%	0.71%	1.15%
Conservative[1]	-0.89%	-1.63%	0.56%	2.72%	1.59%	3.30%	3.18%
Moderate[2]	-0.48%	-0.86%	1.82%	7.09%	3.05%	4.54%	4.16%
Balanced[3]	-0.02%	-0.26%	3.32%	13.61%	5.47%	6.96%	6.23%
Growth[4]	0.36%	0.31%	5.04%	19.73%	8.01%	9.06%	8.25%
Aggressive[5]	0.65%	1.00%	6.50%	26.18%	9.82%	11.13%	10.29%

[1] Growth Assets 0% - 20%
[2] Growth Assets 21% - 40%
[3] Growth Assets 41% - 60%
[4] Growth Assets 61% - 80%
[5] Growth Assets 80%+

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