

Yield Curves

Australia significantly underperformed in May. We explore potential interpretations and relative value.

We recently highlighted the divergence of US and Australian bonds.

For much of 2018 and 2019, Australian 10yr bonds traded well inside US yields – at the time, due to a slowing economy during the drought contrasted to US stimulus. Australian inflation was extremely low at the time.

Australia 10Y | US 10Y (UTC+10)



source: tradingeconomics.com

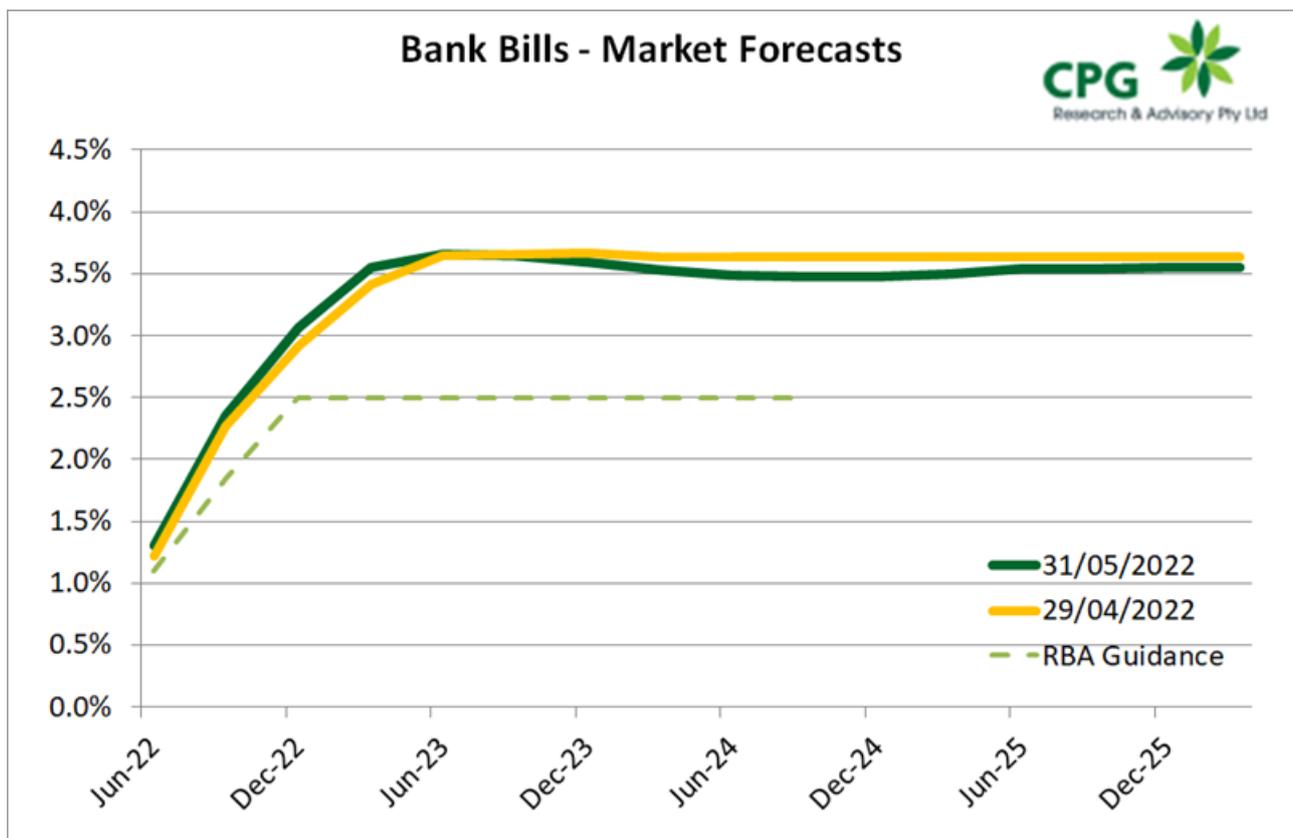
Post COVID recession, both bonds traded in unison for a period.

But since converging at Christmas, **Australian yields have drifted wider and are now 50bp wider – the widest divergence since late 2017**. This is despite:

- ▶▶ Far lower inflation
- ▶▶ Superior budgetary position
- ▶▶ A more dovish central bank

While we are not confident buying long fixed rates at a time of soaring global inflation, this also translates to a steep yield curve at the short end.

There is less price risk, and greater visibility of central bank outlooks, and rates are far above guidance:



It appears that **some consensus is forming**, and markets now have a view: *At what level is the economic damage so great that central banks cannot go any further?* In Australia, that level is **just above 3½% - in USA it is between 3-3½%**.

This would mean that **inflation doesn't matter, other than directionally**. Central banks can't fix inflation, so they won't try – **this isn't the Volcker era**.

If **inflation doesn't matter**, that explains why bond yields are suddenly much higher in Australia than in USA, despite a core CPI of 3.7% compared to USA's 6.2%. Even Germany's core inflation is marginally higher than Australia's, but German bunds are just 1.13% compared to Australia's 3.43%.

So what determines the different equilibrium interest rates, as markets see them?

- ▶▶ **Australia and other commodity exporters** have some offsetting benefits from the current economic shock, and **could avoid recessions**. Yields are a lot higher in Mexico; Indonesian yields are more than 4% above Thailand.
- ▶▶ **Policy cycle** – Australia is probably moving into a period of government expansion. Incoming governments have a large backlog of policy ideas. Those ideas are never *"Let's raise taxes and just use the money to shrink the deficit."* (At least if they are, they never get elected.) Conversely, **USA is likely to face austerity in 2023** under a Republican Congress with a Democratic President (the only combination that ever brings fiscal conservatism).
- ▶▶ A **less hawkish central bank**, with the RBA only moving rates ones (by +25bp to 0.35%). Canada, UK and USA are all at 1% and have normalised 50bp moves. The RBNZ is at 3% after its most recent moves have been 2x50bp. Markets may believe that going hard and early will result in a lower target than getting even further **behind the curve**.

After the GFC, *"bad news was good news"* as it kept interest rates supportive. **This is different, where bonds rallying likely reflects economic pessimism.**

Leading Markets

Stocks stabilised despite recession fears. The US Dow Jones and S&P500 were almost flat at +0.3% and +0.2% but the NASDAQ fell -1.9%. MSCI World ex-AUS returned -0.2% in local terms.

Emerging Markets added +0.4% in \$US, with Latin America and China A strong. Frontier slumped -6.4% after sharp falls in Kazakhstan, Vietnam and Pakistan.

US 10-year bonds reached a cyclical high 3.2% before closing at 2.86% (-8bp). High yield eased to 422bp spread (+22bp) having almost reached +500bp.

Other Highlights

COVID19 deaths passed 6.3m (+50k, vs +85k in April as the northern hemisphere warmed), from 533m reported cases (+20m). The world reached 60% 2nd vaccination (+1%).

US unemployment was steady at 3.6% in April with non-farm Payrolls also unchanged +428k. Participation eased to 62.2% (-0.2%). Youth unemployment was 7.9% (-0.3%). Q1 GDP second estimate was -0.35% actual (-1.5% p.a.).

Inflation eased to +8.3% YoY (-0.2%) after a +0.3% month; core inflation eased to +6.2% (-0.3%), both off 40+ year highs. Retail sales rose +0.9%.

Eurozone prices rose +0.6% in May to a record +8.1% YoY, with energy +39% YoY. Core CPI jumped to +4.4%, also a record, up +0.9% MoM. Retail sales fell -0.4%. The Russian rouble is +23% YTD, prompting Europe to further restrict energy imports but likely increasing the risk of recession.

China reopened at month end after 2 months of rolling COVID lockdowns. Earlier, Services PMI fell to 36 – the lowest outside the first COVID19 showdown. Unemployment rose to 6.1% (+0.3%) and inflation increased to 2.1% (+0.6%). The trade balance improved to +\$US51bn, from +47bn.

Japanese inflation reached 2½% (vs 1.2% in March) after +0.4% MoM, the first time since the 2014 Abenomics spike that the BoJ has achieved its 2% inflation target.

Domestic

The RBA's May meeting raised rates by +0.25%, the first since 2010, as the RBA conceded inflation is not transitory.

As expected, the election produced a majority Labor government – with the final seat a spare to allow them to provide a Speaker. Their agenda will involve a massive expansion of government.

New COVID19 cases hovered around 50k / day with deaths rising to 50 / day (a 0.1% case fatality rate).

2-year yields soared to 2.74%, from 2.56%. 10-year bonds closed 3.35% (+11bp) after hitting 3.60% intra-month.

The ASX200 returned -2.6% with the Small Ordinaries -1.5%.

The wage price index rose +0.7% QoQ to be +2.4% YoY.

Overseas travel rose to 600k, compared to a pre-COVID peak of 2.2m.

CoreLogic reported -0.1% from property in May as buyers digested a rate increase, led lower by east coast capitals. The capitals still average +12% YoY.

Unemployment remained 3.9% matching 48-year lows, with 66.3% participation (-0.1%). Employment rose +4k (but fulltime +92k) to 13.4m, +399k YoY. Underemployment fell -0.2% to 6.1%. Youth unemployment rose to 8.8% (+0.5%). Hours worked rose +1.3%.

Mineral exploration rose +4.7% to \$969m. The current account surplus weakened to \$5.7bn (-24%). 2021's foreign liability eased to \$809bn vs \$992bn in 2020. March's trade surplus rose to \$9.3bn (+25%).

Retail sales were +0.9% in April. Building approvals fell -2.4% and are -32% YoY.

Commodities and Currency

WTI oil rose to \$US114/bbl (+11%). Gold fell to \$US1836/oz (-3.2%). Iron ore slid to \$US139/t (-2.2%).

Base metals slumped with Nickel -10.7%, Zinc -5.6%, Aluminium -7.3%, Copper -3.3% and Tin -14.5%.

\$A recovered to US71.87c (+1.8%).

KEY FINANCIAL MARKET DATA – AS AT 31ST MAY 2022 (UNLESS SPECIFIED)**Interest Rate Markets**

Index Performance	1 month	3 months	6 months	1 year	2 year	3 year	5 year
					p.a.	p.a.	p.a.
Bloomberg AusBond Bank	0.03%	0.02%	0.04%	0.05%	0.06%	0.36%	0.97%

Key Rates	May-22	Apr-22	Mar-22
Australian Cash Rate	0.35%	0.10%	0.10%
90 day BBSW	1.18%	0.71%	0.23%
3 Yr Commonwealth Bonds	2.98%	2.83%	2.29%
10 Yr Commonwealth Bonds	3.35%	3.24%	2.77%
CDX North American 5 Yr CDS	79bp	84bp	66bp
iTraxx Europe 5 Yr CDS	87bp	90bp	73bp
iTraxx Australia 5 Yr CDS	108bp	97bp	86bp
US Fed Funds Rate	0.75-1.00%	0.25-0.50%	0.25-0.50%
US 10 Yr Bond Rate	2.85%	2.94%	2.35%

Equity Markets

Domestic	1 month	3 months	6 months	1 year	2 year	3 year	5 year
					p.a.	p.a.	p.a.
S&P/ASX 200 TR	-2.60%	3.21%	1.44%	4.84%	15.95%	7.85%	8.84%
S&P/ASX Small Ordinaries TR	-7.01%	-3.58%	-11.02%	-4.56%	9.98%	5.50%	8.49%
S&P/ASX 200 A-REIT TR	-8.73%	-7.06%	-10.55%	3.27%	13.37%	2.25%	5.66%

International	1 month	3 months	6 months	1 year	2 year	3 year	5 year
					p.a.	p.a.	p.a.
US: S&P 500 (\$US)	0.18%	-5.16%	-8.85%	-0.30%	18.28%	16.44%	13.38%
US: NASDAQ (\$US)	-1.93%	-11.96%	-21.96%	-11.53%	13.64%	18.44%	15.34%
MSCI World Acc. (Local Currency)	-0.23%	-4.23%	-7.82%	-1.36%	16.22%	13.01%	10.03%
MSCI World Acc. (AUD)	-0.86%	-4.63%	-10.30%	2.71%	11.29%	11.35%	10.54%
FTSE 100 (£)	1.13%	3.34%	9.81%	12.40%	15.89%	5.79%	4.17%
MSCI Emerging Markets (\$US)	-0.50%	-6.22%	-11.15%	-13.49%	5.84%	3.79%	4.57%

Fixed Interest Markets

Bonds	1 month	3 months	6 months	1 year	2 year	3 year	5 year
					p.a.	p.a.	p.a.
Bloomberg Global Agg TR AUD	-0.66%	-7.04%	-12.21%	-6.35%	-8.40%	-2.57%	0.83%
Bloomberg AusBond Composite	-0.89%	-6.02%	-8.02%	-8.54%	-4.95%	-1.76%	0.99%
ICE BofA US High Yield TR USD	0.25%	-4.29%	-6.02%	-5.00%	4.60%	3.16%	3.42%

Data*	Current Period		Previous Period	
<i>Employment Data</i>				
Employment Growth	April	4,000	March	17,900
Unemployment Rate	April	3.90%	March	4.00%
Participation Rate	April	66.30%	March	66.40%
<i>Lending Finance</i>				
Housing Finance	April	-6.40%	March	1.60%
Personal Finance	April	-3.70%	March	-0.40%
Business Finance	April	-8.50%	March	23.60%
<i>Other</i>				
Balance on goods and services	April	10,495m	March	9,738m
Retail Sales	April	0.90%	March	1.60%
Building Approvals	April	-2.40%	March	-18.50%

*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	-2.72%	2.00%	0.83%	4.25%	16.37%	7.77%	7.89%
Australian Equity Small Cap	-6.62%	-4.73%	-11.03%	-3.41%	14.17%	8.18%	8.97%
Global Equity Large Cap	-0.84%	-5.02%	-9.22%	-1.82%	10.17%	9.21%	9.08%
Global Equity Small Cap	-1.56%	-7.69%	-16.43%	-9.51%	9.75%	8.54%	7.83%
Australian Fixed Income	-0.99%	-6.35%	-8.46%	-9.14%	-4.94%	-1.93%	0.73%
Global Fixed Income	-0.29%	-5.19%	-8.33%	-7.97%	-3.82%	-0.95%	0.79%
Australian Listed Property	-8.53%	-6.59%	-9.72%	3.36%	13.31%	2.15%	4.85%
Australian Cash	0.03%	0.01%	0.03%	0.04%	0.09%	0.36%	0.95%
Conservative ¹	-0.81%	-2.63%	-4.31%	-4.04%	-0.28%	0.38%	1.62%
Moderate ²	-0.88%	-2.57%	-4.53%	-2.65%	2.52%	1.91%	2.70%
Balanced ³	-1.03%	-2.13%	-4.24%	-1.11%	6.03%	4.04%	4.41%
Growth ⁴	-1.44%	-2.19%	-4.98%	-0.65%	8.51%	5.53%	5.61%
Aggressive ⁵	-1.51%	-1.63%	-5.01%	0.38%	11.62%	7.37%	7.06%

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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