Australian Income Securities Research

Monthly Review November 2013

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MORNINGSTAR®

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News and Outlook

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This month we are focusing on the outlook for short-term benchmark rates (that is, bank bill swap rates, or BBSW) and their importance for income investors. At present, the benchmark rate represents between 40% and 50% of the absolute yield for most securities which, from a historical perspective, is high. However, the big questions remain which direction are rates likely to go and how will this influence investor decisions.

Historically, the BBSW is closely correlated with the official Reserve Bank of Australia, or RBA, cash rate (see Figure 3) with any deviation normally associated with changes in market expectations for the direction of the official cash rate. Therefore, our expectations for the BBSW are closely associated with factors driving domestic monetary policy. The RBA's mandate for monetary policy is to maintain price stability and full employment while promoting economic growth. The primary mechanism used to achieve these goals is setting the official cash rate at a level that guides inflation to within the 2% to 3% target over the medium term. This has historically been an effective tool but it is not the only tool at the disposal of the RBA.

Why is this relevant? Primarily because the RBA finds itself in an unusual position whereby unauthododox policy measures by its foreign counterparts are manipulating financial markets through excessive liquidity. This in turn has kept the Australian dollar well above its natural long-term level, making our exports more expensive. This has not been a major issue in the past few years as foreign capital has been driving investment (led by the mining sector) which has been a significant contributor to gross domestic product, or GDP. The problem is the mining investment cycle has peaked (or is close to a peak) and there is an unwarranted expectation for net exports to be a significant contributor to GDP to partially offset any decline in mining investment.

In a recent speech to the Australian Business Economists, the Governor of the RBA, Glenn Stevens, suggested "extraordinary monetary policy measures in the US, Japan, and the euro zone" have added to the complexity in assessing the exchange rate. This suggests that even those responsible for managaing the country's fiscal position are struggling with how to contain the currency given the mandate of targeting inflation.

The interest rate futures market seems to be suggesting that we have seen an end to the easing cycle and in late 2014 / early 2015 we may start seeing the RBA tighten policy as growth accelerates. If this is true, we will see benchmark rates follow suit and yields will rise.

However, this all depends on what the global central banks do next and how this will influence the Australian dollar. Our opinion has always been that the RBA could continue easing until a point of 0% real interest rates, but as inflation starts to gather pace, we think the probability of another cut is being weighed up against currency intervention. This is not a battle the RBA will take on lightly as the potential for significant accounting losses will majorly disrupt the federal government's ambitions to balance the budget.

So where does this leave us? In reality, we are at the mercy of the U.S. Federal Reserve and its opinion on what is necessary to get the U.S. labour market to be fully functional even though the Fed's ability to stimulate the real economy is limited by the zero boundary for interest rates. We continue to believe the RBA will sit on its hands until after the Federal Open Market Committee, or FOMC, meeting in January (and further debt ceiling debate) and continue "jawboning" the currency down. If in the coming quarters there is further deterioration in the domestic economy, then the RBA will cut rates, but it is unlikley to intervene in the currency unless there is a material upswing in the Australian dollar from current levels.

Based on this, we believe benchmark rates are likely to remain fairly flat for the next three to six months and we have a slight bias to rising in 2015.

1. Recommendation Changes Since Last Month

- There are no recommendation changes this month.

2. New Issues, Maturities and Resets

- On 11 November 2013, AMP Limited announced it had completed the bookbuild for AMP Subordinated Notes II (ASX:AMPHA) and was increasing the size of the deal from AUD 200 million to at least AUD 300 million. The final deal size will depend on the overall amount of applications received, but the margin was set at the low end of guidance at 2.65% above BBSW. Morningstar will pick up coverage on AMP Subordinated Notes II shortly after its listing date on 17 December 2013.
- On 12 November 2013, National Australia Bank announced a new tier 1 issue, NAB Convertible Preference Shares II. These securities are the second tier 1 hybrid securities

issued by National Australia Bank in 2013 and are almost a carbon copy of National Australia Bank Convertible Preference Shares (ASX Code: NABPA). In our presale report, we recommend investors subscribe at a margin of 3.30% or more above BBSW. Due to high demand National Australia Bank announced it was increasing the size of the deal from AUD 750 million to AUD 1,500 million and set the margin at 3.25% (the low end of guidance).

3. Outlook – Official Cash Rate

The November monetary policy meeting minutes showed a number of policy-specific factors were discussed but, importantly, the bank lowered its growth forecast for second-half 2014 from 3.5% to 2.5%. The long-term trend is around 3% and therefore it was revising the pace from above trend to below trend. The expectation for inflation remained at 2.5% and hence there is an expectation of no real growth in 2014. There is an argument that this is enough to drop rates further, but the expectation is for growth to pick up to above trend in 2015 (2.75% to 4.25%) and hence part of the reason why the RBA has not cut rates further.

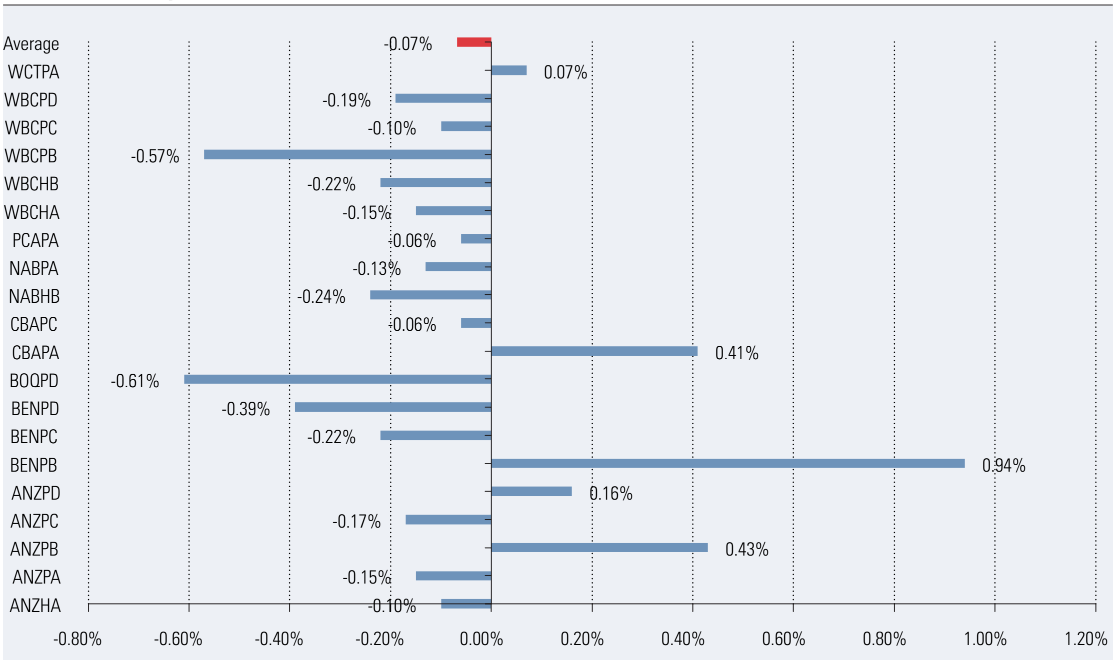
The questions of what is going to replace the growth from mining investment, and is it timely and sufficient to equate to a jump in output from 2.5% in 2014 to 3.5% in 2015, remain. There seems to be a lot of market expectation around infrastructure spending and net exports to fill this gap, which in good in theory, but the reality is infrastructure normally requires substantial lead time before real spending commences. We hope that this proves to be correct and the government introduces sufficient legislation to fund the backlog of projects.

At its last meeting, the RBA board commented "it was prudent to hold the cash rate steady while continuing to gauge the effects, but not to close off the possibility of reducing it further should that be appropriate to support sustainable growth in economic activity". This was in line with our expectations (that is, leaving the door open to further cuts) and doesn't change our view that we are nearing the bottom of the easing cycle. Although the growth figures do not look fantastic, there has been a meaningful uptick in confidence and a clear focus on productivity. Even though interest rates are at a 50-year lows, growth and inflation are not at 50 year lows. We believe that if the currency reverts to a level commensurate with its long-term trade weighted average then we will see a meaningful improvement in our business competitiveness and there will be no need for further easing.

Bank Capital Securities

- In our view, the recent low level of volatility in the overall market is supportive of stable income with some capital upside for more mature securities. Credit curves are likely to steepen slightly (that is, trading margins on newly issued securites are likley to widen) if we see increased systemic volatility in early 2014.
- On 4 November 2013, Westpac Banking Corporation announced its full-year results for 2013. Statutory profits increased 14% to AUD 6.8 billion with moderate revenue growth (up 4%), good cost control (expenses up 4%) and a sharp improvement in bad debts (down 30%). Although the payout ratio of 76% remained stable, the special dividend (following the interim special dividend) was considered a credit negative, especially considering the possibility of domestic systemically important financial institution capital requirements. We expect net interest margins to recover somewhat in 2014 and bad debts to remain benign around 20 basis points of average loans outstanding.
- Commonwealth Bank of Australia continues to deliver solid earnings growth, with unaudited first-quarter fiscal 2014 cash profit up 14% on first quarter 2013, to approximately AUD 2.1 billion. There are no adverse surprises, with all key earnings drivers (loan growth, net interest margins, fee and trading income, cost control and bad debts) consistent with our long-term positive view on Australia's four major, wide-moat-rated banks
- A replica of National Australia Bank's convertible preference share deal in ealy 2013 was announced during the month and bookbuild saw it upsized to one of the largest new issues for the year.

Figure 1: Bank Capital Securities – Trading Margins (change on month) as at 26 November 2013

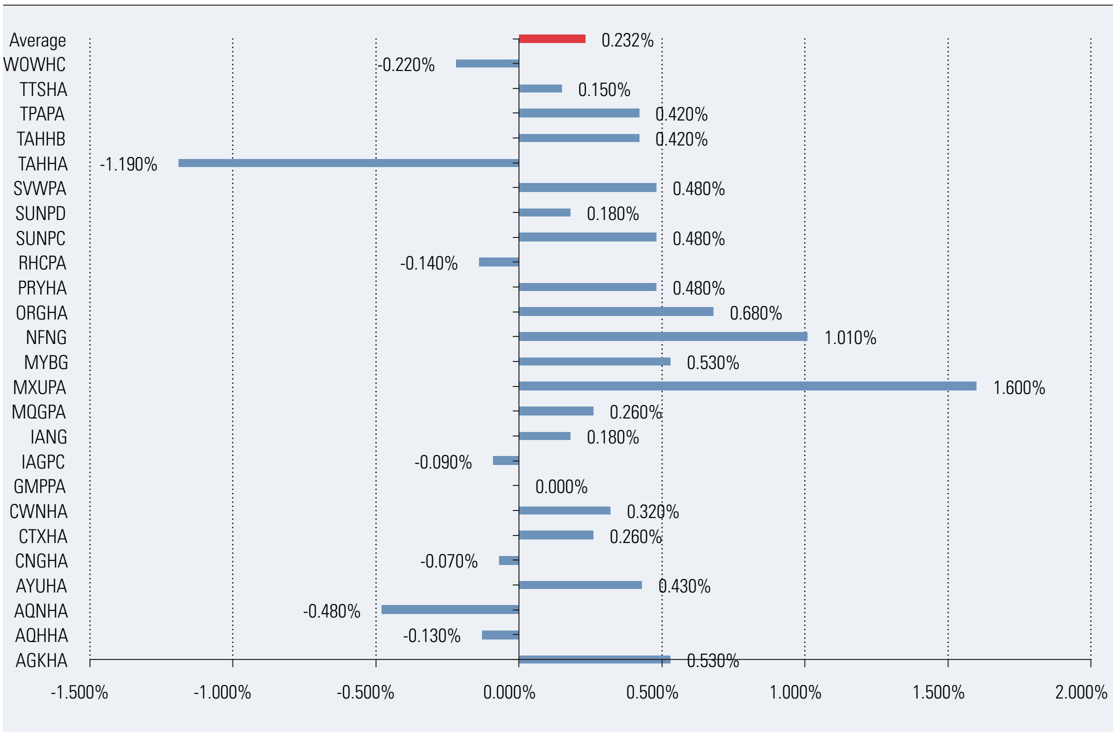


Source: Morningstar

Non-Financial Corporates

- On 12 November 2013, Seven Group Holdings announced plans to implement a major restructuring of the Westrac Australia business. WesTrac's restructuring and redundancies will result in a pretax significant charge against earnings of AUD 13 million in the first half of fiscal 2014. The restructuring is occurring due to the challenging market conditions and lower demand for Caterpillar equipment as the mining companies significantly restrict capital expenditure. In August, we anticipated fiscal 2014 EBIT falling by 45% and net profit after tax, or NPAT, falling by 42%.
- Woolworths' sales performance for the September quarter comes with no real surprises as the company generates a 4.5% increase in sales from its core food and liquor division.
- On 7 November 2013, Goodman Group gave it quarterly business update. It continues to benefit from strong institutional investor demand for its higher-yielding industrial assets, securing an additional AUD 1.8 billion of equity commitments in the September quarter 2013. This leaves the Goodman platform in good shape for growth, with a total of AUD 5.8 billion in uncalled equity and debt. There were no major surprises in the update, but work in progress, or WIP, for the development division is tracking slightly ahead of expectations, rising from AUD 2.2 billion in June to AUD 2.5 billion in September.

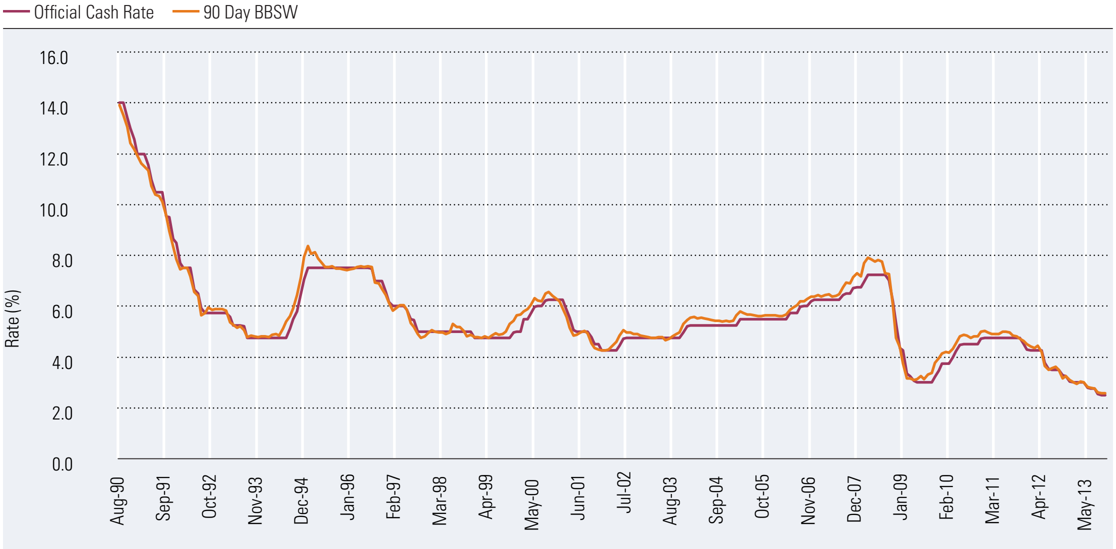
Figure 2: Floating Rate Securities – Trading Margins (change on month) as at 26 November 2013



Source: Morningstar

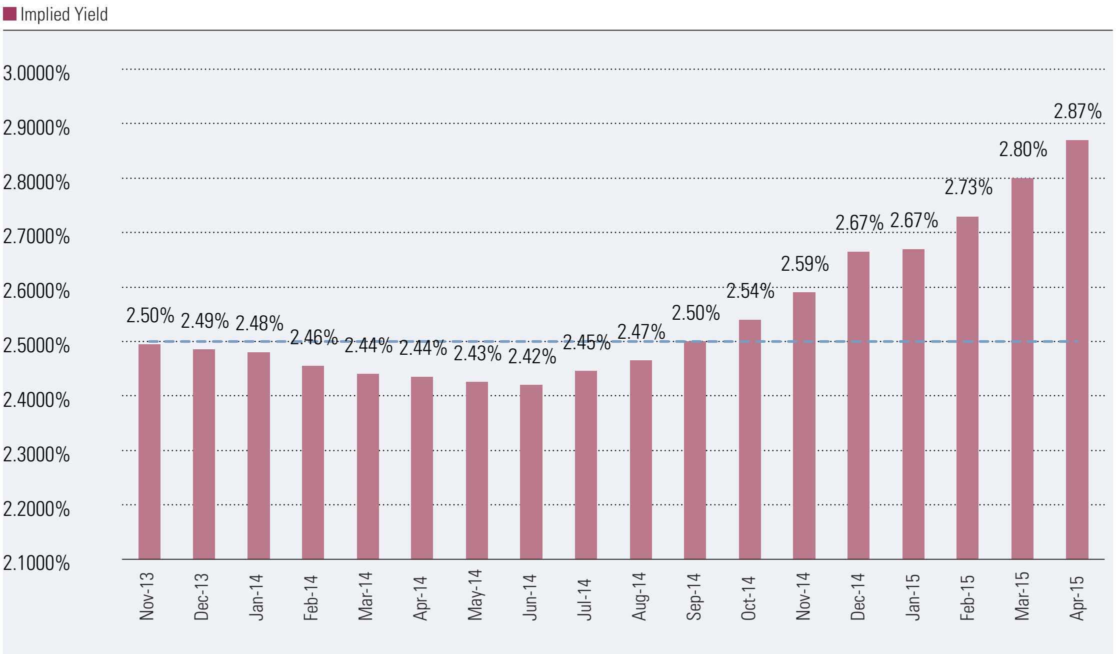
Chart Pack

Figure 3: 90-Day Bank Bills vs Official Cash Rate



Source: Morningstar, Reserve Bank of Australia

Figure 4: Interest Rate Futures Implied Cash Rate



Source: ASX

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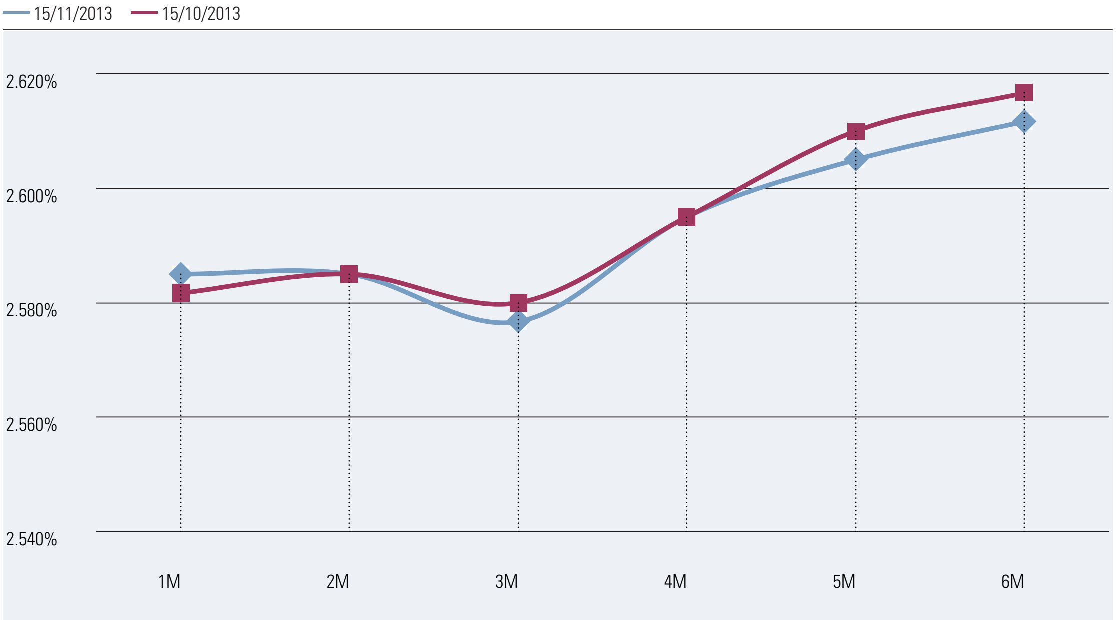
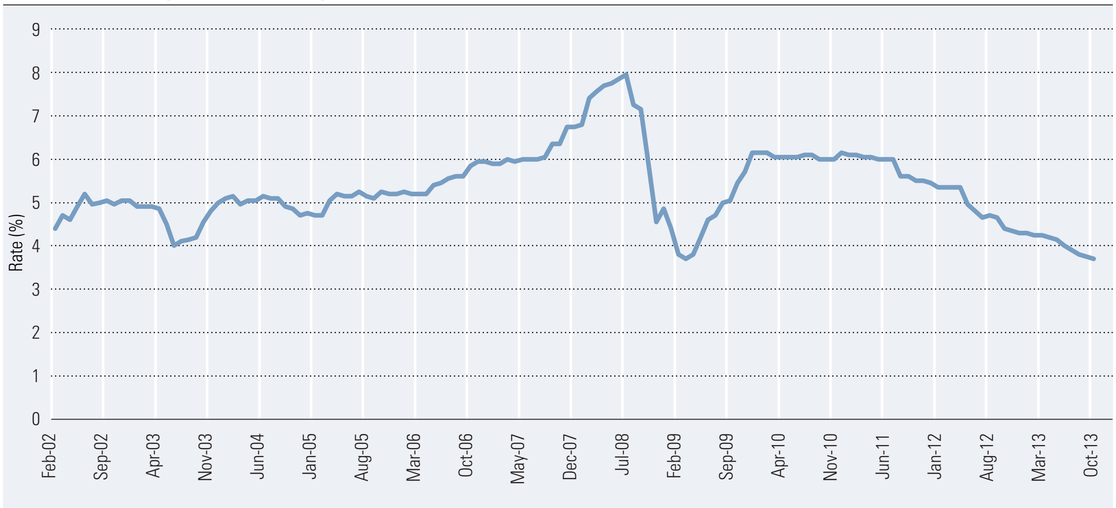
Figure 5: Money Market Curve (Interest Rate Swaps)



Source: AFMA

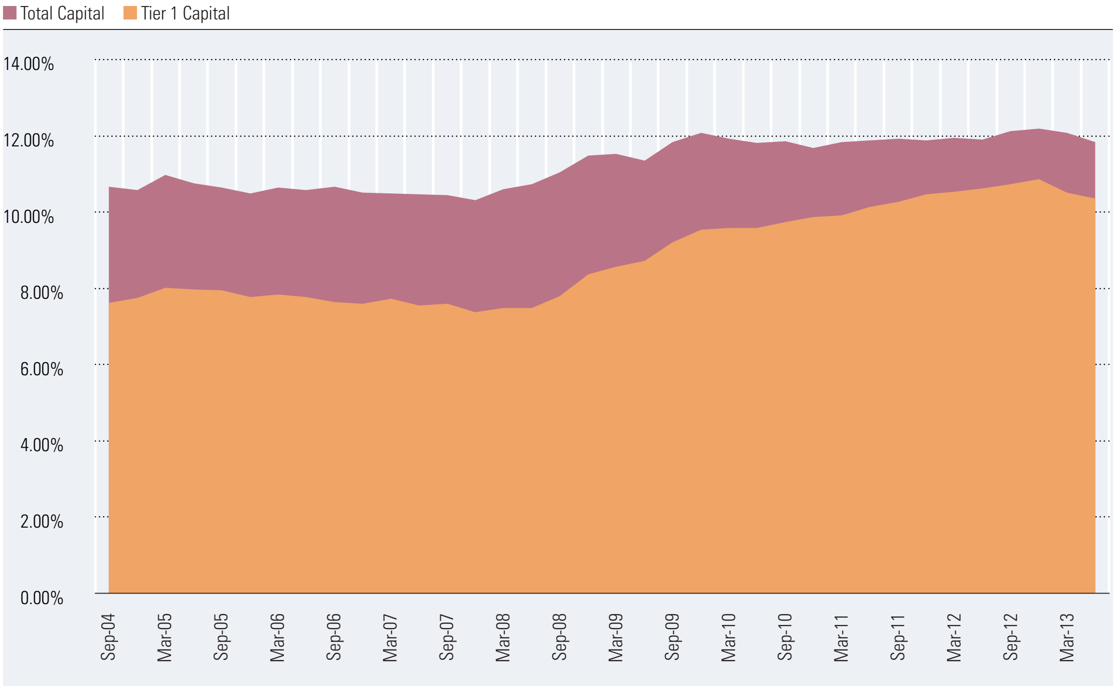
Figure 6: Term Deposit Average 'Special' Rate (All Terms)



Source: Reserve Bank of Australia

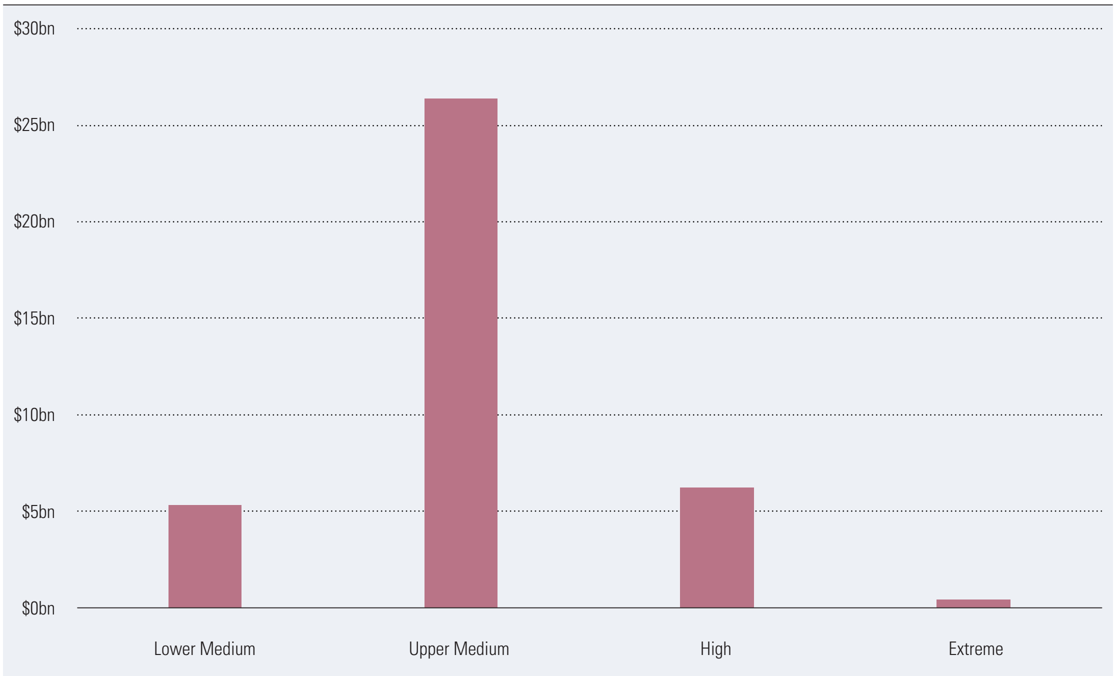
Chart Pack

Figure 7: Australian Bank Capital Components



Source: APRA

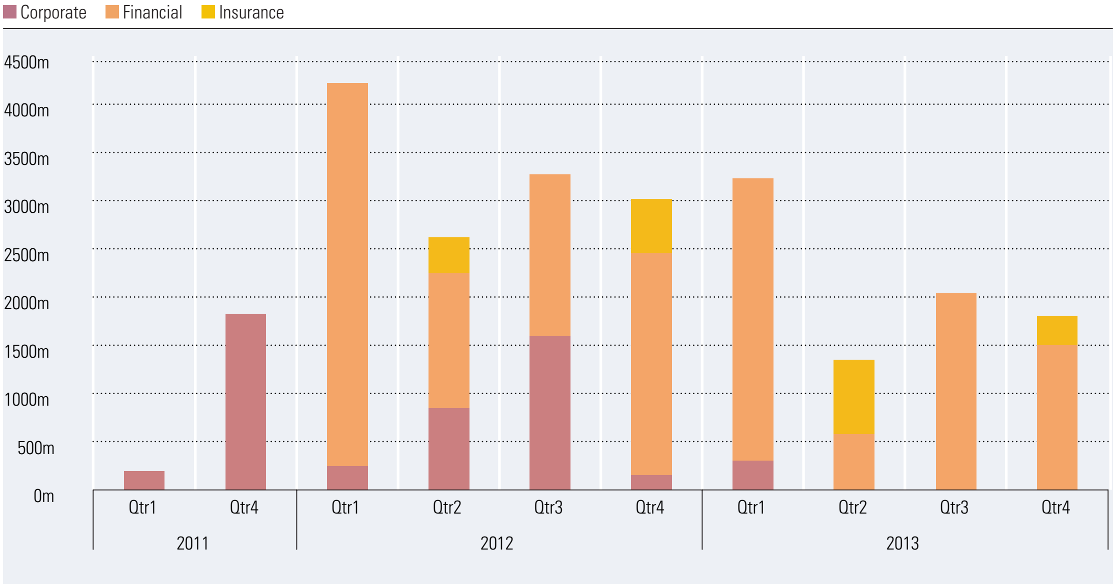
Figure 8: Market Issuance by Issuer Risk Bucket



Source: Morningstar

Chart Pack

Figure 9: New Issuer Monitor



Source: Morningstar

Rate Sheet at 25 November 2013

				Issue Size	Years To	Trading	Running Yield		Yield to Reset		Dist	
Code	Recommendation	Price (AUD)	Issuer	(AUD m)	Maturity	Margin	inc Fr	ex Fr	inc Fr	ex Fr	(AUD)	Ex Date
AGKHA	Hold	104.65	AGK	650.00	5.53	2.79%	6.24%	6.24%	5.48%	5.48%	1.59	25/11/2013
ANZHA	Hold	103.69	ANZ	1508.65	3.54	2.01%	5.30%	5.30%	4.62%	4.62%	1.32	6/12/2013
ANZPA	Accumulate	100.32	ANZ	1970.00	3.05	2.90%	5.79%	4.05%	5.59%	3.86%	0.99	25/11/2013
ANZPB	Accumulate	99.96	ANZ	1081.21	0.55	2.16%	5.18%	3.63%	4.83%	3.38%	0.89	25/11/2013
ANZPC	Accumulate	101.30	ANZ	1340.00	3.76	3.13%	5.84%	4.09%	5.85%	3.96%	1.98	10/02/2014
ANZPD	Hold	102.00	ANZ	1120.00	7.76	3.32%	6.10%	4.27%	6.03%	4.12%	2.38	17/02/2014
AQHHA	Hold	105.45	APA	515.00	4.34	3.42%	7.00%	7.00%	6.15%	6.15%	1.78	17/12/2013
AQNHA	Hold	101.90	AMP	300.00	0.46	1.45%	7.43%	7.43%	3.87%	3.87%	1.85	3/02/2014
CBAHA	Hold	100.05	CBA	575.00	2.07	1.24%	3.70%	3.70%	3.90%	3.90%	0.91	31/12/2013
CBAPA	Accumulate	202.35	CBA	2000.00	0.92	2.68%	6.08%	4.26%	5.33%	3.32%	2.14	18/01/2014
CBAPC	Hold	104.35	CBA	2000.00	5.05	3.14%	6.35%	4.45%	5.81%	3.77%	1.11	2/12/2013
CNGHA	Accumulate	102.76	CNG	1000.00	3.34	2.69%	5.86%	5.86%	5.35%	5.35%	1.47	17/12/2013
CTXHA	Hold	106.30	CTX	550.00	3.80	3.16%	6.96%	6.96%	5.84%	5.84%	1.77	2/12/2013
CWNHA	Hold	107.60	CWN	531.97	4.79	3.62%	7.36%	7.36%	6.27%	6.27%	1.89	2/12/2013
GMPPA	Hold	100.21	GMG	326.97	4.09	4.13%	6.72%	6.72%	6.95%	6.95%	1.69	17/12/2013
IAGPC	Hold	103.00	IAG	377.37	3.42	3.21%	6.59%	4.62%	5.91%	3.85%	2.30	15/04/2014
IANG	Hold	104.51	IAG	550.00	6.05	3.40%	6.55%	4.58%	6.09%	4.00%	1.15	2/12/2013
MBLHB	Accumulate	79.80	MQG	400.00	-	2.85%	5.53%	5.53%	-	-	1.08	20/12/2013
MQGPA	Hold	100.80	MQG	600.00	4.56	3.76%	6.69%	4.68%	6.49%	4.47%	2.92	25/11/2013
NABHA	Accumulate	73.95	NAB	2000.00	-	2.64%	5.31%	5.31%	-	-	0.96	24/01/2014
NABHB	Hold	103.25	NAB	1172.51	3.55	2.12%	5.33%	5.33%	4.75%	4.75%	1.32	4/12/2013
NABPA	Accumulate	100.70	NAB	1541.33	5.31	2.97%	5.86%	4.10%	5.67%	3.91%	1.00	29/11/2013
ORGHA	Hold	102.90	ORG	900.00	3.07	3.44%	6.65%	6.65%	6.12%	6.12%	1.64	9/12/2013
PCAPA	Accumulate	190.92	CBA	1166.46	2.35	3.24%	3.89%	2.72%	6.11%	4.86%	1.25	20/12/2013
RHCPA	Hold	104.00	RHC	260.00	-	4.65%	7.41%	5.19%	-	-	2.73	30/03/2014
SUNPC	Accumulate	105.12	SUN	560.00	4.05	3.68%	7.18%	5.02%	6.35%	4.02%	1.26	4/12/2013
SUNPD	Hold	100.90	SUN	770.00	4.98	2.67%	5.50%	5.50%	5.36%	5.36%	1.40	10/02/2014
SVWPA	Hold	86.40	SVW	496.36	-	5.91%	8.72%	6.11%	-	-	2.64	11/11/2013
TAHHA	Accumulate	101.58	TAH	284.00	0.42	1.56%	6.93%	6.93%	3.78%	3.78%	1.76	3/02/2014
TAHHB	Hold	104.40	TAH	250.00	3.31	3.01%	6.55%	6.55%	5.65%	5.65%	1.64	9/12/2013
TTSHA	Hold	104.35	TTS	194.66	5.60	2.40%	5.62%	5.62%	5.06%	5.06%	1.41	19/12/2013
WBCHA	Hold	102.60	WBC	1676.22	3.73	2.01%	5.31%	5.31%	4.68%	4.68%	1.35	11/02/2014
WBCHB	Hold	100.05	WBC	925.28	4.73	2.31%	4.98%	4.98%	4.99%	4.99%	1.24	10/02/2014
WBCPB	Accumulate	102.15	WBC	908.33	0.84	2.68%	6.48%	4.53%	5.16%	2.80%	1.12	17/12/2013
WBCPC	Accumulate	101.89	WBC	1189.36	4.34	3.02%	5.93%	4.15%	5.72%	3.85%	2.03	17/03/2014
WBCPD	Accumulate	100.60	WBC	1383.57	5.27	3.04%	5.87%	4.11%	5.73%	3.95%	1.01	25/11/2013
WCTPA	Accumulate	95.31	WBC	762.74	2.59	3.08%	3.84%	2.69%	5.93%	4.70%	0.67	6/12/2013
WOWHC	Hold	104.48	WOW	700.25	2.99	1.73%	5.71%	5.71%	4.38%	4.38%	1.47	11/02/2014

Glossary

BBSW	The Bank Bill Swap Rate (BBSW) is the average mid rate for Australian dollar bills of exchange accepted by an approved bank, having a tenor with a designated maturity that appears on an approved information vendor's service (e.g., Reuters Screen BBSW page).
Conversion	Under certain circumstances, the hybrid security may be converted into a number of ordinary shares of the underlying stock at a specified conversion number, subject to terms, conditions and corporate events, including conversion discount, conversion date and triggers.
Conversion Discount	A discount in percentage applied to the underlying stock price into which the hybrid security may be converted. Also referred to as exchange discount.
Conversion Number	The number of ordinary shares of the underlying stock into which the hybrid security may be able to convert. For certain hybrid securities, there may be a minimum and/or a maximum conversion number applied. The conversion number is generally calculated based on a formula: Conversion Number = Face Value / [VWAP x (1 – Conversion Discount)]
Convexity	A measure for bonds used in conjunction with modified duration in order to measure how the bond's price will change as interest rates change. It is equal to the opposite of the second derivative of the bond's price relative to its yield, divided by its price. For example, since a non-callable bond's duration usually increases as interest rates decrease, its convexity is positive.
Cumulative	Depending on the hybrid security, the dividend, distribution or coupon paid may or may not be cumulative. If the dividend, distribution or coupon is cumulative and if the issuer defers the payment of the dividend, distribution or coupon on any payment date, then additional dividend, distribution or coupon will accrue at the prevailing distribution rate.
Dividend Yield	Expressed as a percentage, dividend yield is the company's annual dividend payments divided by its market cap, or the dividend per share divided by price per share.
Duration	The change in the value of a fixed-income security that will result from a 1% change in interest rates. Duration is stated in years. For example, a five-year duration means the bond will decrease in value by 5% if interest rates rise 1% and will increase in value by 5% if interest rates fall 1%. Duration is a weighted measure of the length of time the bond will pay out.
Exchange	Exchange means the conversion, redemption, buy-back or cancellation of the hybrid security.
Face Value	The face value of the security is the issue price typically being AUD 100 per security.
Gross	Yield expressed, inclusive of any available franking credits or tax-deferred benefits.
Margin	Expressed as a percentage per annum, the margin offered by the hybrid security over a reference rate. The initial margin is typically determined by a bidding process within a prescribed margin range known as bookbuild. For certain hybrid securities, the margin may be increased (refer to Step-up) at a predetermined date.
Market Rate	See Reference Rate.
Mandatory Conversion	Some securities include a mandatory conversion condition, which forces conversion if the underlying stock price is above some threshold level and the issuer chooses not to redeem the security for face value.
Net	Yield expressed, exclusive of any available franking credits or tax-deferred benefits.
Reference Rate	Typically a floating reference rate (e.g., 90-day BBSW) used to reference the periodic coupon payment of a hybrid security. The reference rate is generally applied at the beginning of a distribution period for the upcoming distribution. Also referred to as the market rate.

Reset	For certain hybrid securities, on a reset date, the issuer may reset certain terms including the next reset date, the dividend/distribution rate, the conversion discount and the timing of frequency of dividend/distribution payments. Resets may mean significant change to the terms of the hybrid security and as a result investors may or may not accept such new terms. Further, the issuer may elect to redeem or to exchange the hybrid security. As such, Morningstar has a conservative approach to treating resets and considers it as a probable maturity. In tables and abbreviations, we use "Reset" to refer to any step-up, mandatory conversion, call or other pseudo-maturity event.
Running Yield	The hybrid's annual coupon payments expressed as a percentage of the market value of the security.
Step-up	For certain hybrid securities, the margin above the reference rate may be increased or stepped-up at a predetermined date upon the occurrence or non-occurrence of a certain event (e.g., non-conversion at a specified date).
Tax Deferred	The distribution of certain hybrid securities may have a tax-deferred component (may be less than 100%), which allows the distributions to be tax deferred over a certain period. The tax-deferred distributions are not assessable to Australian income tax upon receipt for most investors, but instead reduce the cost base of the security for capital gains tax purposes and as a result defer tax until the disposal of the security. Securities offering a tax-deferred component may give rise to tax benefits. Changes to tax legislation may have the effect of reducing the tax-deferred component of distributions. Investors should seek professional taxation advice in relation to dealing in these securities and their individual situation.
Time to Maturity/Reset	The time expressed in number of years from now to a reset date, conversion date, step-up date and/or maturity date, where on such date, either the terms of the security may change or the security may be repurchased, redeemed, exchanged or converted.
Trading Margin	In simple terms if an issuer already had securities on issue, they could expect any new securities with $100 face value to trade close to the trading margin. The Trading Margin of a security s is the effective margin at which s trades; it is the margin which a new security n with face value of AUD 100 would need so the sum of the discounted cash flows of n equal the discounted cash flows of s assuming redemption of both s and n at the pseudo-maturity date of s. The calculation is grossed up for franking where appropriate.
VWAP	The average of the daily volume weighted average sale price of ordinary shares sold on ASX during the relevant period subject to specific terms and adjustments of the relevant hybrid security offer.
Volatility	The degree to which the price of a security tends to fluctuate.
Yield to Reset/Maturity (YTR/YTM)	The hybrid's internal rate of return to reset, step-up or other pseudo-maturity event.

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