FEATURE

JAPANESE BUYER LOWDOWN

Demand from Japanese investors – particularly life-insurance accounts – has been perhaps the greatest driver of high-grade Kangaroo deal flow in recent years. *KangaNews* spoke to seven Japanese institutional investors, some of whom preferred to remain anonymous, as well as key Japan sales staff from TD Securities (TD), to get a handle on the motivations, preferences and outlook of this key investor sector.

BY LAURENCE DAVISON AND SAMANTHA SWISS

Getting a clear handle on the precise level of Japanese investor contribution to supranational, sovereign and agency (SSA) Kangaroo deal flow is not straightforward. There are no aggregate deal-distribution figures in public circulation, and at least some of the Japanese-origin flow into the sector comes into deal books via allocations to Australian and global funds-management firms.

However, data from individual deals and other anecdotal evidence from a range of market participants suggest that the Japanese bid dominates long-dated issuance. Although not all the market's long-dated bid comes from Japanese buyers – and investors from Japan do not exclusively buy long-dated paper – the prevalence of extended-tenor issuance should therefore act a reasonable proxy for Japanese demand for the Australian dollar SSA asset class. On this basis, the role played by Japanese investors is somewhere between significant and dominant.

According to KangaNews data, for most of the past five years close to half of aggregate SSA Kangaroo issuance has come to market with duration around the 10-year mark. The A$12.8 billion (US$9.6 billion) of long-dated SSA Kangaroos priced in 2014 was an all-time record, while the willingness of Japanese buyers to allocate to the asset class via small, ad-hoc tap transactions has radically reshaped the characteristics of deal flow.

In 2010, SSA Kangaroo deal volume was A$20 billion. This total came to market in fewer than 100 individual transactions. While 2015's volume was almost identical, the last full year of SSA issuance in Australia featured more than 200 deals – a substantial majority of which were long-dated taps for less than A$100 million. This dynamic is, market participants agree, largely the product of the specifics of Japanese investor demand for long-dated Australian dollar issuance.

POINTS OF COMPARISON

However, information from individual Japanese investors suggests that while there are some common underlying themes behind their demand for Australian dollar product, their investment preferences and outlooks are far from homogeneous. Buyer commentary also suggests that some widely held views about Japanese investors, specifically that they tend to stick firmly to buy-and-hold principles, are not entirely accurate (see box on p22).

The most obvious common factor is growth in demand for foreign-currency-denominated exposures among Japanese end investors – especially life-insurance clients – as a response to Japan's negative interest-rate environment. "The demand for Australian dollars is increasing," one Japanese life-insurance investor tells *KangaNews*. "Our firm started providing new Australian dollar-denominated insurance product last year,

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AKIRA TAKEI MIZUHO ASSET MANAGEMENT

because the extra-low yield environment is making foreign currency-denominated products needed in Japan."

Other firms report that their Australian dollar demand is stable rather than increasing, but largely because they have already established significant positions in the currency. In other words, Australian dollar investments have carved a strategic niche within the investment universe and show no sign of losing it.

"Our demand for Australian dollars remains strong – it has not changed in the past year – because single-payment whole-life insurance with Australian dollars as the liability currency continues to sell well in Japan," says Takahiro Yamaguchi, deputy manager, investment-planning department at Mitsui Sumitomo Primary Life Insurance (Mitsui Sumitomo Primary Life) in Tokyo.

The first and most obvious differentiating factor among Japanese investors is where the underlying FX risk lies. Takeo Otsuka, head of fixed-income sales, Japan at TD in Singapore, explains that some wholesale investors hedge foreign-currency exposures at institutional level while others – perhaps those responsible for the bulk of growth in inflows – are offering Australian dollar denominated products to retail investors. In this case, the ultimate FX risk lies in the retail sector.

As a result, Otsuka adds, the cost of hedging foreign-currency exposures may be overstated as a motivating factor for Japanese investors as a whole. "It is true that hedging costs have increased – it now costs around 1.5 per cent to hedge US Treasuries in yen, effectively ruling out the asset class for hedged Japanese buyers," he explains. "But actually the predominance of unhedged buyers out of Japan makes currency direction, rather than hedging cost, a much more significant driver of demand sentiment."

FX OUTLOOK

Naturally enough, there is not a single, unitary view on currency direction among Japanese investors. Although buyers have generally tended to be wary of adding exposures to foreign currencies in general in recent months, Ryo Miyazaki, Singapore-based director, fixed-income sales, Japan at TD, says some buyers now see supportive fundamentals. "Currency views depend on the individual client, and some certainly continue to hold a negative outlook on commodities – which naturally supresses demand for Australian dollars," he tells *KangaNews*. "But the general mood in retail is different. These investors have seen the yen strengthening over an extended period, by around 25 per cent, and on a long-term basis they tend to see foreign currencies as relatively cheap as a result."

Even if the relative view on Australian dollars is mixed, the scale of funds inflows means a natural allocation to the currency is close to inevitable. Miyazaki reveals a substantial volume of cash is flowing into Australian dollar-denominated life insurance every day in new-money form, with a large proportion of this seeking Australian dollar exposures – mostly in the form of SSA and high-grade financial-institution (FI) securities. The production line of small SSA Kangaroo taps is easy to explain in this context.

In fact, FX outlook in many cases trumps expectations around rates direction as a motivating force for Australian dollar allocations. "Even at 2 per cent Australian dollar bonds still look attractive on a yield basis, and for hedged investors like us there is the potential to alloate more to the currency," confirms Akira Takei, Mizuho Asset Management (Mizuho AM)'s Tokyo-based chief fund manager, global bond and FX active strategy investments. "In fact, if I was asked what I plan to do next, I would say I will increase Australian bond exposure rather than reduce it – even though I have already accumulated quite a lot of Australian bond exposure."

Takei adds: "However, for the time being it is impossible to rule out further appreciation in the yen. So we think further increases in Australian dollar exposure from unhedged investors in Japan could be on hold for some time."

Takei explains further that Mizuho AM has seen value in Australian bonds since the start of 2015 and in the Australian dollar since the beginning of the final quarter of last year. He comments: "As far as bonds are concerned, lower yields in Japan and Europe and the different shape of the Australian yield curve relative to other major bond markets have made Australia an attractive option. As for the currency, we concluded that the weak trend of the Australian dollar against the US dollar since 2011 would come to an end more recently, due to the Federal Reserve postponing and then giving up on rate hikes."

For some investors, it is impossible to look at relative rates or FX outlook in isolation. One fund manager explains: "There is no change for us when it comes to the level of yield. What has happened is that our expectation around the currency rate has fallen, since there is little cushion coming from rates themselves."

NEGATIVE YIELDS

The most significant single driver of Japanese investor interest in foreign-currency-denominated assets as a whole is the suppressed level of domestic yields. Some investors say the transition from low to sub-zero returns on high-grade, yen-denominated securities has taken the allocation challenge to a new level – especially for funds with defined-benefit liabilities. "In my opinion, negative yield is serious problem," says a life-insurance investor. "Our basic investment style is buy-and-hold, and we prefer stable income return than unstable capital return."

> "A growing number of Japanese investors are adjusting their ratings requirements when it comes to Australian dollar bonds – even those for whom FX exposure is the main driver."
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> **TAKEO OTSUKA** TD SECURITIES

BUY AND – MAYBE – HOLD: LIQUIDITY AND JAPANESE INVESTORS

Japanese investors in Australian dollars say that, while they are often willing to hold securities for extended periods, they still have a potential need for liquidity in the secondary market.

All seven Japanese institutional investors who spoke to *KangaNews* report that secondary liquidity is of at least some interest. While some say they tend to be buy-and-hold in style, all acknowledge the possibility of having to liquidate positions and thus keep an eye on secondary-market conditions.

Many say their mandates demand liquidity. "Secondary liquidity is very important, including in Australian dollars," reveals Takahiro Yamaguchi, deputy manager, investment-planning department at Mitsui Sumitomo Primary Life Insurance.

He adds: "Single-payment, whole-life insurance has a function of automatic redemption and we will need to sell in the secondary market when triggered by key factors. In this respect, we look at liquidity based on outstanding, tenor and asset class."

The same message comes from fund managers. Akira Takei, chief fund manager, global bond and FX active-strategy investments at Mizuho Asset Management, explains: "We trade in and out as markets and our portfolio conditions change, so secondary-market liquidity is quite relevant to us."

Liquidity conditions

Just like their peers in Australia, Japanese investors are aware of the challenges around liquidity provision in the contemporary environment. For example, Takei tells *KangaNews*: "We are aware that liquidity in the secondary market is not as robust as it was before, so we are more inclined to be active in the primary market to construct our portfolio."

To some, trading conditions cast Australian dollar investments in a relatively poor light. One life-insurance investor tells *KangaNews*: "Although we are a buy-and-hold type of investor, there are some cases in which we have to sell. In this sense, secondary liquidity is important – and compared with other markets, like US dollars, Australian dollar liquidity is poor."

Elsewhere, views on liquidity in Australian dollar securities seem to come down to the asset classes in which the specific investor is active. And it is clear that views are more positive at the top end of the credit spectrum.

Indeed, Yamaguchi suggests that while Australian dollar liquidity conditions are worse than those in US dollar markets they are "improving every year".

One fund manager adds: "Liquidity is quite important for us, but to date we have not been concerned about bid-offer spreads especially in Australian Commonwealth government bonds. This is because there are a lot of brokers involved in the market and as a result it is highly competitive."

The picture is less clear when it comes to Japanese funds active in the Australian dollar credit sector. For example, Yoshisada Ishide, senior fund manager, foreign fixed-income group at Daiwa SB Investments, comments: "We are not a buy-and-hold investor though our typical holding period is apparently longer than some others. Even so, liquidity has been an important subject for the Australian dollar credit market because turnover in credit tends to be smaller."

The situation is different for Japanese asset managers, but even they agree that the hunt for yield is likely to be the main driver of willingness to explore foreign-currency allocations. "Negative yield is not a huge problem for us given our main 'competition' is against a benchmark," says one fund manager. "But we think other market participants would be quite nervous."

The key dual appeal of Australian yield is that it is both positive in absolute terms and relatively higher than what is available elsewhere. Given these two fundamental supporting factors, more normal investment criteria can apply. An investor at another life-insurance company that sells one-time-payment Australian dollar insurance tells *KangaNews*: "Our investment goal in Australian product is to keep income above the level offered by Australian Commonwealth government bonds [ACGBs]. Spread compression matters as a result, but any reduction in absolute yield has basically no impact."

Australia's declining cash rate over recent years certainly did not come as a huge shock to the global investor community as a whole – and Japanese buyers are quick to point out that they were not outliers in this respect. Takei comments: "We anticipated a significant fall in yield in Australia and therefore we are happy to stick with Australian bonds going forward – at least until they reach the same point as Japanese yields."

As with any global investment, allocation expectations for Japanese buyers largely rest on a fluid matrix of absolute and relative yield expectations – quite apart from the currency overlay that is, for many Japanese investors, even more important than the rates and spread situation. While the picture is not absolutely

"Until a few years ago, very high-grade triple-A securities were enough to meet our liability cost. However, under the escalation of the competitive environment we have needed to take both credit and liquidity risk in order to secure higher yields."

TAKAHIRO YAMAGUCHI MITSUI SUMITOMO PRIMARY LIFE INSURANCE clear, the fundamentals are again arguably more positive than negative. "Demand from Japan will likely remain solid for as long as Australian rates are in positive territory," says TD's Otsuka. "Of course the issue of the relative position of Australian yields to Japanese yields is relevant. And while there doesn't seem to be much likelihood of Japanese rates returning to positive territory there is at least a question of how negative they can go. But the fact remains that there are a lot of Japanese investors who can't or won't buy negative-yielding bonds, and these buyers have to put their funds somewhere."

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RYO MIYAZAKI TD SECURITIES

ASSET MIX

What has changed as a result of declining Australian rates is the willingness of some Japanese investors to explore asset classes outside the domestic government and SSA sectors. Again, the Japanese buyer base does not present a unified face in this respect, as some funds say they are still content to focus on top-rated securities. For instance, Takei says Mizuho AM invests in ACGBs, Australian semi-government bonds and SSA names – and has "no plans to expand our assets in Australia beyond these".

This seems to be the minority approach, however. "A growing number of Japanese investors are adjusting their ratings requirements when it comes to Australian dollar bonds – even those for whom FX exposure is the main driver," Otsuka reveals. "We are seeing some who have allocated to mortgage-backed securities in the US, for instance, and who are now also engaged with the positive yields this asset class offers in Australian dollars."

Most of the investors who spoke to *KangaNews* say they continue to focus on vanilla bonds in Australia, but also that they have either had FI and corporate credit on the radar for some time or have recently started exploring opportunities in a wider range of credits.

Yamaguchi at Mitsui Sumitomo Primary Life comments: "Until a few years ago, very high-grade triple-A securities were enough to meet our liability cost. However, under the escalation of the competitive environment we have needed to take both credit risk – such as that offered by single–A corporate securities – and liquidity risk in order to secure higher yields."

Another Japanese life-insurance investor tells *KangaNews* that the firm has recently diversified its Australian dollar allocations away from its traditional focus on SSAs supplemented by ACGBs and semi-government bonds. It now includes FI issuance in its allocations purely as a means of maintaining spread levels in the low-return environment.

The move to diversification within Australian dollar assets has not been lost on those Japanese buyers that have been involved for a longer period. Yoshisada Ishide, senior fund manager, foreign fixed-income group at Daiwa SB Investments (Daiwa SBI) in Tokyo, says: "We have been investing in the Australian dollar credit market from the start – but we are certainly aware that Japanese institutional investor demand for Australian dollar credit is stronger than ever."

In fact, some Japanese investors are sufficiently engaged with Australian dollar credit that they are already well versed in the diversity issues that local issuance patterns have never quite been able to shake off. For instance, Yamaguchi explains that while his firm is satisfied with the range of SSA names active in Australian dollars, it would be happier if local credit issuance had a greater weighting towards corporate, as opposed to FI, names.

ISSUANCE FORMAT

A development that has caught the eyes of a number of Japanese investors is the use of global formats for Australian dollar issuance. These buyers are, naturally enough, not tied to Australian domestic format. They have no requirements when it comes to local index inclusion, and indeed may be more comfortable from a legal perspective with the use of EMTN or global programmes.

If the historical success of global SSA issuers with Japanese investors in the Uridashi and Kangaroo markets is anything to go by, the desire for diverse credit issuance in Australian dollars on the part of Japanese investors could be the precursor of more international corporate issuance in the currency. At this stage in market development, though, it is hard to draw strong conclusions about a preferred jurisdiction for Australian dollar issuance documentation.

Takei at Mizuho AM comments: "We tend to prefer international formats as we expect the kinds of investors participating in international formats are, literally, international – meaning there should be breadth of investor base."

By contrast, Daiwa SBI's Ishide says he prefers domestic-documented deals in the Australian dollar market – though his reasons for doing so appear to be the same. He says the fact that most market participants already accept domestic transactions as the norm gives him comfort around this style of deal. •

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