GLOBAL NETWORK OVERSIGHT

The global supranational, sovereign and agency (SSA) sector satisfies its huge funding task in an array of currencies and issuance formats, supported by investors from every sector and geographic location. *KangaNews* spoke to key SSA market executives at **TD Securities** to get the latest insights into global investor sentiment and issuance dynamics.

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SSA MARKET RATES RESPONSE

Davison Our sense is that the true nature of what 'longer' means in 'lower for longer' is only now really starting to settle in among global investors. How are you seeing SSA investor behaviour changing in response to the rates environment?

■ **COSTANZO** There have been a few interesting themes. One has been analysing investor preferences around issuer names. Some buyers have always preferred the tighter-priced category, looking at the lack of perceived liquidity in some of the cheaper names and using this as a reason to justify not doing the quantity of additional credit work required to consider other issuers when they come to market. But there has been a lot of change here, and it's a theme we have seen accelerate along with negative interest rates.

Low rates is one thing, but when rates go negative it provides an aggressive catalyst to investors to be more creative. A sense of urgency isn't something we have seen historically in, for instance, the Japanese investor base – but it is growing both there and elsewhere.

Again, we have traditionally seen central banks in Europe saying they would never buy particular names or certain currencies but now, with negative rates as the trigger, we have seen the floodgates open to new names. Obviously we're focusing on the SSA world for the sake of this discussion, but if we stand back we've seen these, often very conservative, accounts even moving away from SSAs and buying high-grade corporates and financials.

■ **ALOISI** If we were in an interest-rate environment with 5 per cent yields on US Treasuries and an extra 20 basis points on top for SSAs, the added value of buying SSAs would be limited. It is much clearer when you're looking at 0 per cent bond yield and 20 basis points for SSAs. Therefore I would say the lower-rate environment is playing in SSAs' favour, especially in the benchmark markets such as US dollars and euros.

But it is not only in these markets. In general, it is in the currencies in which the rate environment is pretty close to zero where SSAs add a lot of value at the moment.

There is a reason why we are at these levels of interest rates, though, and it is because the global outlook is not excellent.

"Investors can't just keep on going out along the curve. They have used this tool to confront negative rates, but it has a limit – and now they are being forced to look at other things."

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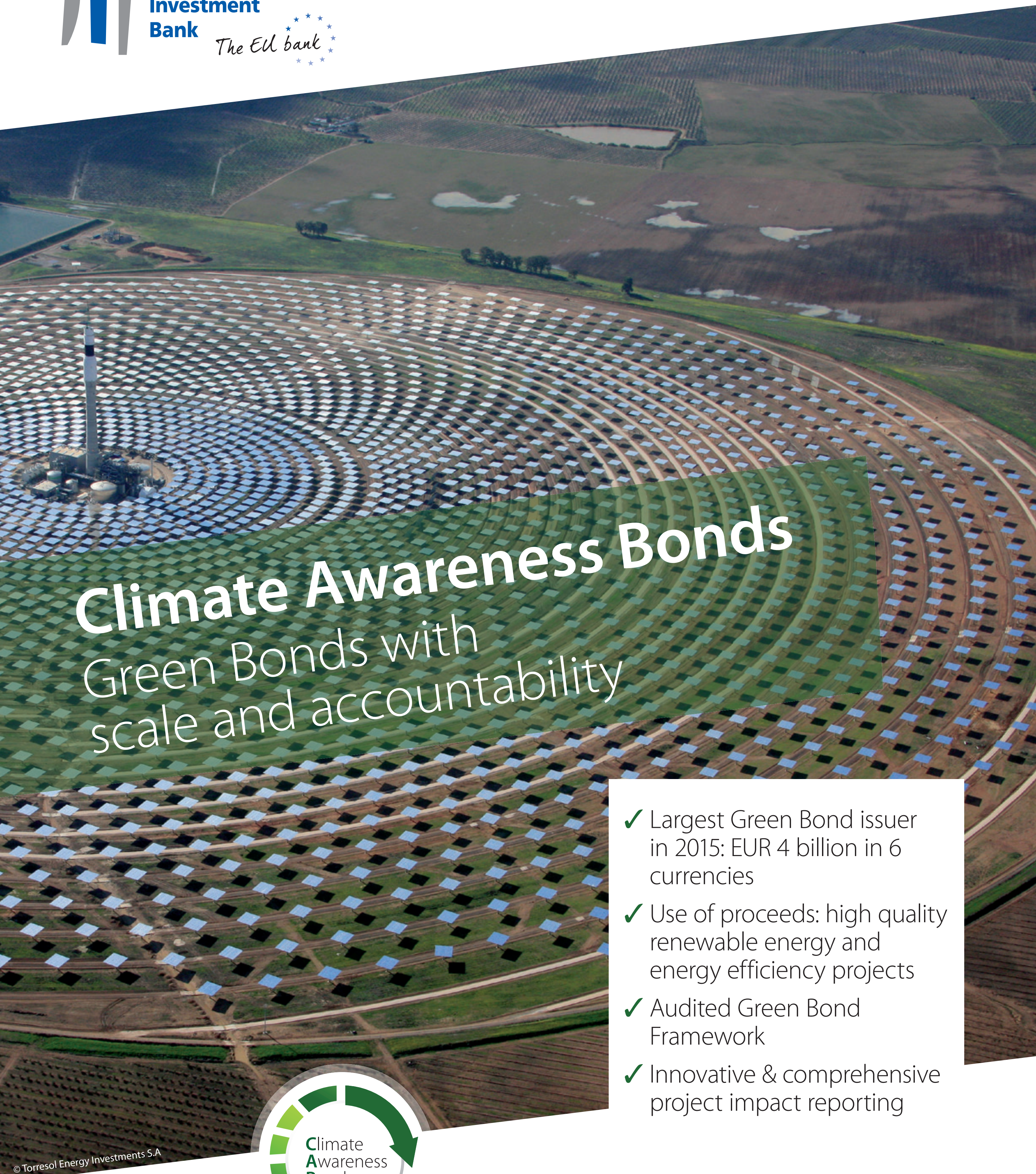
European Investment Bank

The EU bank



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"We have seen investors going outside their historical comfort zones to achieve investment objectives. Investors who said they would not buy beyond five years are now looking at 10, and those who said they wouldn't consider buying certain credits are doing so."

TOM IRVING TD SECURITIES

What this means is that while one might think with the lower-rate environment investors might walk away from fixed income, in fact this is not what's happening in the SSA space. We are seeing more buyers coming into this sector, and others adding to it. If I look over the last five years, the SSA investor base has increased dramatically – because of regulation, due to a yield play and for liquidity reasons.

■ **IRVING** It's the same story in Australian dollars – but it is taking a little longer to work through the low-rate environment in Australia. Now mid-dated Australian dollar high-grade paper is yielding less than 2 per cent, some investors are pausing and this is leading to less issuance in this part of the curve. But this is temporary in our opinion.

The main themes, though, are the same. We have seen investors going outside their historical comfort zones to achieve investment objectives. Investors who said they would not buy beyond five years are now looking at 10, and those who said they wouldn't consider buying certain credits are doing so.

Davison It has been suggested that Australian dollar investors have perhaps been somewhat prone to sitting on their hands when it comes to low rates – tending to be short duration and waiting for things to 'improve'. Is this a fair assessment?

■ **IRVING** One thing that is different in Australian dollars compared with other markets is the steepness at the front end of the curve. So the incentive to get out of cash has been relatively limited, because investors are not getting a huge yield pickup by doing so. This is probably why the Australian reaction to low outright rates has tended to be slower.

Having said this, my sense is that if the cash rate in Australia headed down further, let's say to 1 per cent, we would probably see a lot more activity in mid-curve notes. Currently, though, we have had the theme of a relatively strong housing sector that continues to put upward pressure on rates, meaning we have a relatively flat curve. Flat curves are not overly constructive for issuance.

To get strong activity happening in a market, you need interest rates to be moving and central banks to be 'in play'. Currently this is not the case in Australia. Less active markets tend to mean investors default to believing that rates will eventually go up, in line with what's happening in the US.

Davison Is there something about 'going negative' in rates that is different from any other move? In other words, is it a factor of investment markets that the move to -0.5 per cent yield from 0 per cent, for instance, is objectively worse for institutional investors than an equivalent move to 0.5 per cent from 1 per cent?

■ **COSTANZO** There are various discussions to be had in this regard. We can look at actual investor behaviour, specifically what has been triggered by negative rates. In general, all the discussions we have been having with various investor groups – and we've been having them for a long time – are different. The Japanese have been buying multicurrency for a long time but the Europeans haven't, for instance. But the second rates went negative it became a completely different ball game for all investors.

For example, there are even discussions around whether it is even legal to charge customers negative rates. It is one thing to have a bank fee, but to actually charge negative rates has come up several times as something that a lot of entities feel they are legally unable to do. This has been a motivation for investors to ensure that they continue to find assets that offer positive yield, regardless of the rates backdrop.

It feels like there is more work to be done to truly understand this environment. But as soon as rates went negative the way we saw the market manage its funds changed dramatically, and we think this will only continue. So far, SSAs have largely been beneficiaries.

■ **ALOISI** Going into negative-rate territory is when you see major shifts in asset and currency allocations. This is something we are starting to see in Europe.

For example, the European funds-management industry used to be mainly domestic – or euro only. Given where the rates environment is in most of the government markets, we are now seeing some allocation away from the euro into other higher-yielding currencies. This is a major shift.

As long as rates were close to zero but in positive territory nothing really happened, but now rates are in negative territory we are seeing this trend and dynamic accelerate. This is because fund managers cannot survive with negative yields and negative performance given the fees they charge their clients. So we are seeing a global reallocation of funds across currencies: there is definitely more appeal in Australian and US dollars, and even

GREEN SHOOTS TAKE ROOT

Supranational, sovereign and agency (SSA) issuers are leading the charge when it comes to green-bond funding – with the Australian dollar market a relatively recent addition to the mix. The global asset class is maturing rapidly.

DAVISON Treasury Corporation of Victoria (TCV) printed Australia's first domestic semi-government green bond in 2016. However, there has not yet been significant volume of follow-on green issuance from the SSA sector since World Bank and KfW Bankengruppe debuted in 2015. Each issuer will be different, of course, but how are you seeing green bonds growing within the overall SSA global funding programme picture?

WEST This year we have seen issuance well ahead of last year's pace. The only factor constraining the exponential growth we've seen in the past is simply the volume of assets that qualify for socially responsible investment (SRI) funding. Issuers and investors are working together to ascertain how they can continue to develop markets, and issuers are focused on responding to investor demand. In the US, investors are very vocally seeking enhanced yield via longer-dated issuance.

The SSA community has responded and a number of issuers have issued 10-year green-bond transactions. For instance, International Finance Corporation (IFC) issued a 10-year US dollar green bond – a tenor that IFC hadn't issued previously – and this was deliberately executed in green-bond format.

In Australia, one of the key drivers of green-bond growth will be SRI demand. The Kangaroo market has been open for a significant portion of 2016, giving issuers time to refresh their mainstream Kangaroo curves. However, as the year continues, there is every possibility that green will become a focus.

A growing Asian investor base supporting the Australian dollar market could be game-changing for the SRI space.

"A large proportion of the SSA community's assets are socially responsible – for instance, a number of supranationals could consider every bond to be sustainable financing."

AMY WEST TD SECURITIES

DAVISON You mentioned that finding assets has been the barrier to issuance growth in the SSA sector. Some SSAs argue that substantively all their lending adheres to sustainability criteria – so could some of the SSAs issue solely in green-bond format, notwithstanding certification expectations?

WEST A large proportion of the SSA community's assets are socially responsible – for instance, a number of supranationals could consider every bond to be sustainable financing. However, this is unique to SSAs and hard to apply to other asset classes.

What is most important is for the green-bond market to work with investors and provide transparency. The Green Bond Principles Executive Committee made a recommendation this year on external review in order to keep alignment with the green-bond principles as the market develops. The committee actually went so far as to recommend and define external reviews – whether it's a consultant review, verification, certification or ratings review – and provide a template.

sterling, based on the negative-rate environment in Europe and Japan.

IRVING I also think there is some psychology attached to zero and negative yields. There was definitely a conscious shift for issuers to focus on points on the curve where investors knew they could achieve a positive yield.

However, there is now more focus on the European Central Bank (ECB) refinance rate. This rate is currently minus 40 basis points, so zero is 'just another number'. As such, the stigma attached to zero is dissipating.

Davison There are various ways investors can deal with ultra-low rates – including taking more credit risk, increasing duration and looking at alternative currencies. Do you have a sense of which approach is most prominent across the global investor community?

COSTANZO I think duration is the easiest. Just to extend duration and explain why you're doing it – because yield in three years, say, is not enough – is very easy to get credit minds around. Yes there's a risk, but taking more currency risk – where an investor might not have the right valuations or the right people in the team to do this analysis – is a much bigger mind shift. Credit diversification has the same complexities. So I believe it is easiest, by far, to extend duration than either of the other two strategies.

ALOISI I agree. In order, I would put duration first, followed by credit and then currency. Taking FX exposure is the most difficult and therefore the one that it is taking most time to happen.

Davison Is duration by itself sufficient, or have we reached a point where there is simply not enough juice in duration and

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> "If we were in an interest-rate environment with 5 per cent yields on US Treasuries and an extra 20 basis points on top for SSAs, the added value of buying SSAs would be limited. It is much clearer when you're looking at 0 per cent bond yield and 20 basis points for SSAs."
>
> **SALVATORE ALOISI** TD SECURITIES

investors are going to have to start to look at other factors – like credit and currency?

■ **COSTANZO** This is the point we're reaching now: investors can't just keep on going out along the curve. Quite simply, borrowers don't need the extra duration. We talk to lots of issuers who say they would love to take 15- or 20-year money but just don't need it, or they are an agent and their clients are still happy with five years. They may have convinced their clients to go out to seven years and occasionally 10, but they cannot indefinitely go on mismatching their portfolios. Investors have used this tool to confront negative rates, but it has a limit – and now they are being forced to look at other strategies.

I agree that the next component is looking at credit. This is something with which investors can get comfortable. If you're already buying tier-one supranationals it's not a complete strategic shift to start buying a high-grade agency name. These discussions are under way – and if SSA investors keep taking these little leaps it is not hard to see how they will gradually reach, say, a covered bond. I still feel that currency diversification is a step further for many investors, though.

Some investors who are putting their heads in the sand when it comes to taking on currency risk – but what we are seeing is these buyers being squeezed out as a result. Competitors are offering the same clients a multitude of products that weren't previously being offered.

REGIONAL DEMAND SPECIFICS

Davison Moving onto regional specifics, what is the motivational force of the broad swathe of Japanese investment funds that might look at the SSA sector?

■ **IRVING** The currency is still the most prominent factor for any foreign investor in the Australian dollar market, and Japanese buyers are no exception. Once a Japanese account decides to go long Australian dollars the real issue is where it is willing to go in terms of duration and credit exposure.

As has been the case for many investors across the world, typically the Japanese have been more willing to look further out the duration curve rather than down the credit curve. This is where the SSA sector tends to play perfectly for them. But a number of alternatives are available and it's important that issuers remain nimble to react to changes in demand.

It's also worth noting that Japanese monetary and fiscal policy has been difficult to follow at times over the last year or so. Economies and currencies don't operate in isolation, so while central-bank intent may be clear, global factors often mean the intent doesn't land in the desired result. This too has led to a more cautious approach to certain asset classes from Japanese investors.

Davison Are you seeing the same broad drivers among the rest of the global reserve-manager sector – in regions like South America and the Middle East?

■ **ALOISI** In the Middle East in particular there is obviously a link to commodity prices, and some of these investors have been less active on the back of lower oil prices at the start of this year. They have come back since so I would characterise the sector overall as active, with US dollars very much still the focus currency. The main yield play for these investors is in credit, so we haven't seen them becoming significantly more active in other currencies. This is understandable, given their inflows are more or less exclusively in US dollars.

Latin American central banks are, in many cases, being affected by local economic dynamics and, to some extent, also commodity prices. Brazil, for instance, used to be a very big participant in international markets and while it is still active it is to a lesser degree. The same is true across the region.

Davison Moving onto Europe, this is perhaps the investor base that has seen the ground shift under it to the greatest extent in recent years. What dynamics are at play when it comes to the SSA-buying sector?

■ **ALOISI** Looking at the last five years, there has been a massive increase in the European SSA buyer base. This has mainly been driven by bank treasuries which, on the back of regulatory change, have been much more active in the SSA space. This is much more of a long-term trend than one that is based on a rates view.

The next-largest active investor category is asset managers. These buyers are much more inclined to be willing to move away from euros as an investment currency, and also to go down the credit spectrum – a move that has only accelerated as corporate bonds have been added to the European QE programme. These investors have been active in Australian

dollars, but they tend to diversify into the biggest currency market – US dollars – before looking at anything else.

European central-bank behaviour is pretty much unchanged. They have to hold euros, so there hasn't been any noticeable movement in currency or credit exposure.

Davison Finally, what about North American investors? SSAs continue to print significant US dollar volume, of course – but what is the local buyer base doing?

■ **ALOISI** The US dollar qualifies as a high-yielding currency nowadays – so local investors have no need to hold euros, for instance. Indeed, with a few exceptions we see US investors exclusively holding US dollars. Among these exceptions, we see some asset managers holding Australian or New Zealand dollars, but mainly as part of a tactical view as opposed to a strategic asset allocation.

As with Europe, regulation has played very much in SSAs' favour in the US. High-quality liquid asset (HQLA) and liquidity-coverage ratio rules have led to many more small and regional banks becoming active SSA buyers – this simply wasn't the case five years ago. Mortgage-backed securities (MBS) and local agencies do not qualify as level-one HQLAs in the US, but SSAs do – this is a massive change, especially for regional banks that used to invest predominantly in MBS and US Treasuries. The bid for SSAs from this sector has been revolutionised.

Another change has followed a massive marketing effort to US municipalities on the part of the Washington-based supranationals over the past 5-10 years. Some of these investors are moving towards SSAs, not largely because of regulation in this case but because the US muni market is shrinking – and will continue to do so over the next decade. These investors have to buy something, and SSAs is the next logical asset class after US Treasuries.

KAURIS AND KANGAROOS

Davison The last few years have been very positive for the Kauri market, at least in terms of issuance volume. However, notwithstanding the debut of two Korean SSA issuers in 2016 the range of active borrowers remains relatively narrow – and the Kauri market has also not yet developed the long-end bid that has been such a feature of the Kangaroo market. What is your read on Kauri prospects, specifically issuance diversity and duration?

■ **IRVING** The Kiwi market is always going to be smaller than the Australian one, and of late AUD/NZD interest-rate differentials have not been especially appealing as an inducement to do more New Zealand dollar investment.

On the other hand, the Kauri market has certainly benefited from the fact that certain Kauris are unencumbered under local regulation – which means there has been a consistent bid from the bank sector. This bid has evolved, but typically it has a preference to stick with names that have a track record of issuance and proven liquidity – it's not really a buyer base that naturally looks to go aggressively into new names.

Liquidity is the main reason Kauri issuance has focused on a smaller group of borrowers as all investors, not just banks, are demanding more liquidity at the moment.

In the medium term we will see a wider range of issuers but for the time being the focus will be on increasing the size and depth of existing issuers' lines.

I am less convinced that we will see a large long-end Kauri market emerge as I don't think investors differentiate enough between Australian and New Zealand dollars to force them to move away from the 'larger brother'. This said, there would be more hope if policy action sees rates or currency markets differentiate significantly.

Davison Kangaroo demand and issuance dynamics seem to have a habit of changing every few years as the product starts to appeal to a new buyer base or loses its attraction to another. However, the significance of the long-dated bid out of Japan in particular has been perhaps the most obvious factor driving deal flow in the Kangaroo market for some while now. Is there any reason to expect a change in the foreseeable future?

■ **IRVING** I don't see any obvious reason for a change at this point. But it's also important to be aware of the range of products available to Japanese insurance investors. I don't think SSA Kangaroo demand from this sector is going to disappear by any means, but equally I don't anticipate a return to larger transaction sizes. Market participants seem to have adapted to small, regular deal taps and to have grown comfortable with this issuance style provided it doesn't negatively affect performance.

The mid-dated market will continue to be the main driver of Kangaroo volume. It needs a few factors to go in its favour, but it will return.

Davison Are you generally positive or negative on global demand for Australian and New Zealand dollars?

■ **IRVING** What we can't lose sight of is the fact that liquidity is a major driver of investor behaviour nowadays. If an offering is seen as liquid, there is very strong underlying demand for both Australian and New Zealand dollars. The challenge for the market is that investors have higher barriers to entry these days – and we need to continue to react to these.

It's up to us as a market to address these questions. I am confident that we have and will continue to do so – and as a result I am positive on both markets over the long term. •

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