

A Chance to Reset in Debt

It's often said of investing that a rising tide lifts all boats. However, this isn't always true and the uneven bounce back in debt markets in the last two weeks has created some outstanding opportunities for investors to reset their positions. In some cases, debt securities have recovered strongly giving holders a chance to lighten their positions, locking in gains or small losses. In other cases, securities sold off and haven't recovered, making them bargain buys. Here's a quick rundown of the relative opportunities.

Consider selling – government debt

Those who have been long term holders of government debt have seen it serve its primary purpose in the last year; government debt has done well whilst credit and equities have sold off. However, the likelihood of this scenario repeating is very low. Unless the RBA is willing to change its stated policy and drop the Cash Rate below 0.25%, there simply isn't room for government bond yields of up to 5 years to fall much further. Government bonds now offer such minimal returns that capital gains are unlikely and will be small if they occur, whilst capital losses could be substantial. International government bonds carry substantial default risk, few governments have plans to ever balance their budgets let alone pay off their debts.

This asymmetric return outlook makes switching from government bonds to cash or term deposits attractive. Some term deposits and at-call accounts are now paying double the yield on a ten year government bond. This comparison ignores fund manager fees, which could be eating up most or all of the bond yield, leaving investors that stick with government bonds with an expected net return of near zero.

Consider selling – senior bank debt

Compared to the losses on many other debt securities, senior bank bonds have performed particularly well. Fixed rate bank bonds are likely to have reported positive returns this year driven by the gains on the interest rate component. Floating rate senior bank bonds would have taken small losses, but far less than on many other debt sectors. Prices and liquidity today are far better than they were just a few weeks ago and during large parts of the last financial crisis.

If I was a CIO of a large superannuation fund staring down the barrel of a redemption wave, senior bank bonds and government bonds would be the first targets for sale. There's little lost by selling these securities, but a huge benefit in having a higher cash position. It doesn't solve the issues with an over-allocation to riskier assets or the mark to market problem on illiquid assets, but many funds will look to their regular inflows to cover those issues over time.

Consider switching out – subordinated debt

Tier 2 bank bonds/subordinated debt hasn't had the same bounce back that senior bank debt has. Spreads are substantially higher than they were six weeks ago, but are still well below where they got to in the last financial crisis. Given Australian banks are now far better capitalised than when they entered the last crisis and are generally carrying less risk in their corporate and institutional lending books there are reasons to stick with tier 2 debt.

However, there are some concerns about extension risk. [APRA unnecessarily delayed its response to global TLAC reforms](#) meaning Australian banks start this crisis with far less tier 2 debt than they should have. The consensus is that APRA will give banks a holiday in meeting their tier 2 targets, but I'm not convinced this applies if this crisis persists. APRA would be well within its rights to tell banks that there are no more redemptions of tier 2 debt unless they issue additional securities to at least maintain their current capital levels. If APRA was strict, it could instruct banks to continue to grow their tier 2 levels, in line with the TLAC implementation timetable. Australian banks could then be forced to delay their tier 2 redemptions, pending easier conditions for multi-billion dollar issuance.

Consider switching out – bank hybrids (technically equity not debt)

Like tier 2 debt, the consensus is that banks will call their hybrids on or soon after the first call date. If this turns out to be a long and deep crisis, as typically occurs when there are both economic and financial system factors at play, calls could be many years after their call dates. One factor generally ignored is that the share prices of ANZ, NAB and Westpac are trading below the mandated conversion thresholds for at least some of their listed hybrids. APRA could choose to waive these requirements if there is a replacement transaction, but it would be a bad precedent to set.

There's also the potential for dividends to be switched off, either by the bank voluntarily or by APRA decree. This isn't as unlikely as many think. It could simply be a cold calculation by a bank that if equity dividends aren't being paid why bother continuing to pay hybrid dividends? Considering the requirements from overseas regulators to stop paying equity dividends, it isn't difficult to envisage this scenario playing out overseas soon. If Australia sees a recession of similar severity to the 1991/2 recession it is possible that a full or partial cessation of hybrid dividends occurs.

Consider buying – corporate debt & securitisation

Unlike bank debt and hybrids, corporate debt and securitisation sectors have recovered far less in recent weeks. In some cases, those trying to sell securities that have almost no prospect of default are finding they cannot attract a single bid. Those willing to purchase in these sectors need to do so on the basis that these securities may remain illiquid and mispriced for a substantial period. For those that seek to take advantage of the illiquidity premium this is a rare opportunity to increase your prospective return whilst decreasing the risk of default and long-term capital loss.

Written by Jonathan Rochford for Narrow Road Capital on 11 April 2020. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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