This research note in an investor only publication. We hope you find it useful.

Welcome back to average (except Bank Capital securities)

- **While there are lots of reasons why Australian AT1 (hybrids) have remained cheap a number of these reasons are disappearing.**
- **Spread margins on most other income asset classes are revisiting pre GFC levels: Bank capital instruments are still a long way from there.**
- **There is a real risk that there will be no major Bank AT1 issued domestically over the next 12 months, while there are $2.5b of redemptions.**
- **The falling yields on other credit classes will encourage institutions to invest.**
- **Many of the events which scared markets over the past 7 years are resolving themselves.**

Opinion update

We wrote an update in late January after the market had experienced a steroid induced couple of return months. While we thought the market had gone too far too quickly, we thought it was still represented good value in the longer term. Over the next month and a bit, the market returned only 0.17%, or around 0.5% less than the income yield, so you could argue it was getting closer to fair value. Since then, we've changed our minds. We think that many of the reasons for the market to 'mark time' or to even weaken have now disappeared.

Kissing frogs at conferences

We went to 'one of those' conferences last week. Normally, you get a lot of the usual blah blah blah about the economy and liquidity, but when a bank treasurer made a comment about how easy it was to raise money we woke up and took note. Apparently, there is a "wall of money" and offshore investors have not only stopped complaining about bank capital securities; they actually want the banks to issue them (because they are issued at a wider spread margin and at a higher yield).

The result

We went back and did some digging in our data base and the chart that looks like a bowl of spaghetti below is the result. It details the spread margins since March 2007 (start of the GFC) as a percentage of the previous 10 years' average levels (i.e) the bottom (orange-ish) line is for "C" rated bonds and in March 2007, the spread margin of 4.8% was around 40% of the previous decade average of 12.1%. As at February 2017, the margin on the same class was 8.0% - around 66% of the 1996-2007 average. By contrast the Australian bank issued AT1 hybrid spread margin (blue line) is around 350% of its 10 year pre GFC average margin. While it's clear that bank capital instruments become structurally more risky post the GFC, they have been a clear laggard since.

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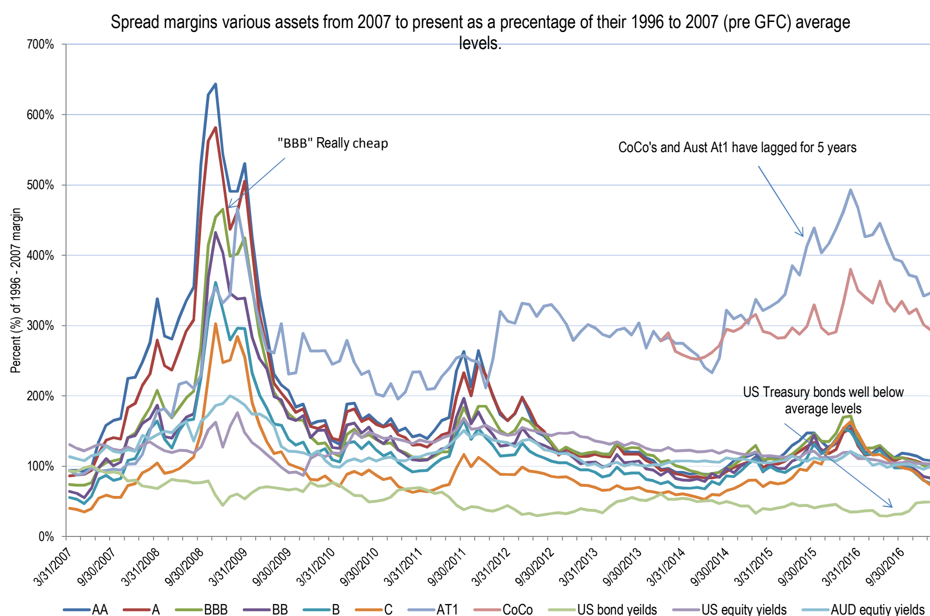

What does this show us?

Forget most of the lines; we've highlighted, from our perspective, the most interesting bits.

- The GFC and the immediate post GFC period was an extreme risk aversion event with margins on every risky asset class more than doubling. Risk aversion has retreated gradually since then.
- This is evidenced by the path of the US bond yield which is at around 50% of pre GFC levels (and March 07 levels are roughly the same as for the previous decade). At the same time corporate bond margins have contracted from way above average levels to around average levels. Equity yields remain at average levels, which is a fall of around 50% from 2011 levels.
- In hindsight low investment grade bonds ("BBB" and "A" levels) were the buy of the century during the GFC. Margins rose to 500% of average levels and there were never going to be enough defaults to justify that margin increase. It's hard to see on the chart, but "BBB" and "A" rated corporate bonds are still above average levels despite the contraction seen over the past 6 or so years.
- In general, spread margins on corporate bonds are now at levels only seen before the GFC, in 2012 (before the first European scares), and in 2014 (before China scares and oil price collapse).
- 2 asset classes have lagged. European CoCo's have not participated in the post GFC rally (there's not data prior to 2013, so we've assumed that CoCo yields were priced the same as Australian hybrids when data started).
- Australian hybrids have lagged even further. Even taking into account that bank capital became riskier after the GFC they are still way above 2007 levels.

Global Bank crisis over?

It's been a long and interesting 9 years, but it looks to us that we are near the end of the post GFC bank crisis. If you can remember back to 2010, most of the large banks in the world had real issues: low capital levels, doubts over adequacy of debt provisioning and

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poor profitability. This was at least part of the reason bank capital securities remained inexpensive relative to other credits. The US problems were solved relatively early but the past 4 years has seen 2 enormous European elephants in the room: Deutsche Bank (DBK) and the Italian banks. Over the past 4 months, the elephants have left the room. Deutsche Bank undertook a massive capital raising, as did the 2nd largest Italian Bank and the ambulant but dead Monte Paschi will be recapitalised. This should lead to a reduction in the fat tail buffer that exists in pricing of bank capital instruments. The table below shows improvement in some important credit metrics. The US now has a well-regarded banking system with good ROEs (which follows through into high price to book) and good capital levels. Europe is still on the journey, although the price to book of 1 reflects an adequate return on capital and the improvement in the 25% level is startling. Markets are telling you the problems have very much diminished.

Metric	US		Europe		Europe (25%)	
	Latest	2011	Latest	2011	Latest	2011
Price to Book	1.3	0.9	1.0	0.5	0.8	0.3
ROE	8.5	9.4	9.4	6.6	7.3	4.3
Tier 1 Equity (US), Tier 1 capital (Europe)	10.2	7.8	16	12.2	13	11.2

So what do lower margins mean?

The lower margins and reducing fear factor have had a number of impacts.

- The margin contraction experienced in all the other corporate bond classes will flow into bank capital securities as institutional investors become increasingly more comfortable with bank capital instruments and chase yield.
- The increased demand from overseas investors will increase the probability of Australian major banks issuing AT1 capital instruments offshore at lower than current spread margins.

Australian AT1; lower yields offshore

The chart below shows the spreads margins, AT1 CoCo's and Australian bank hybrids. We've split them up by the credit rating of the issuing bank (Australian banks at "AA-"are amongst the best rated banks in the world). For example BBVA (rating "BBB+") has a CoCo with a 2.6 year duration (2020 maturity) that trades at a spread margin of 6.8%. The most interesting aspect is that the AT1 that ANZ issued in mid-2016, denoted by the mauve triangle in bottom right hand of chart below, is the most expensive CoCo and trades at a spread margin around 0.6% below new issue Australian AT1 hybrids (and that is for a 10 year security). The spread margins of Australian AT1 hybrids are trading currently around the levels of banks with "A" credit ratings.

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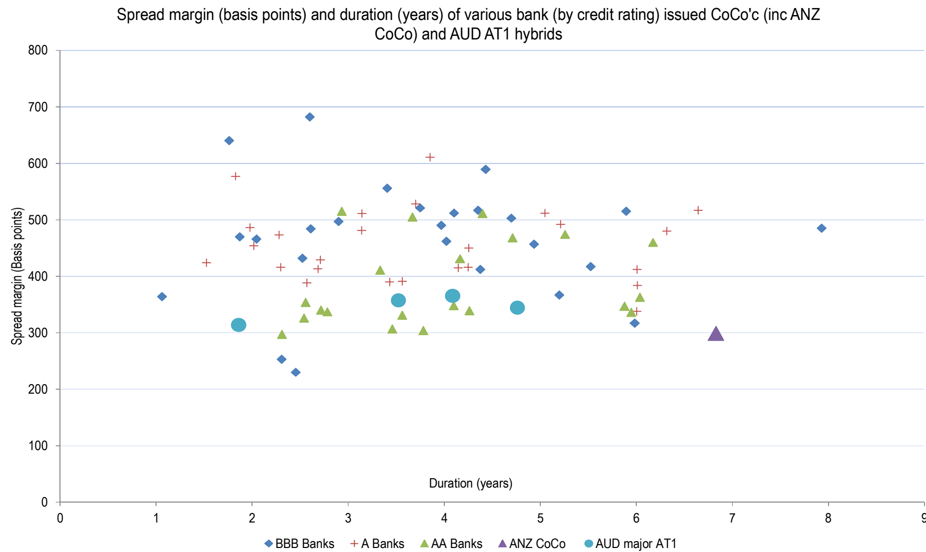
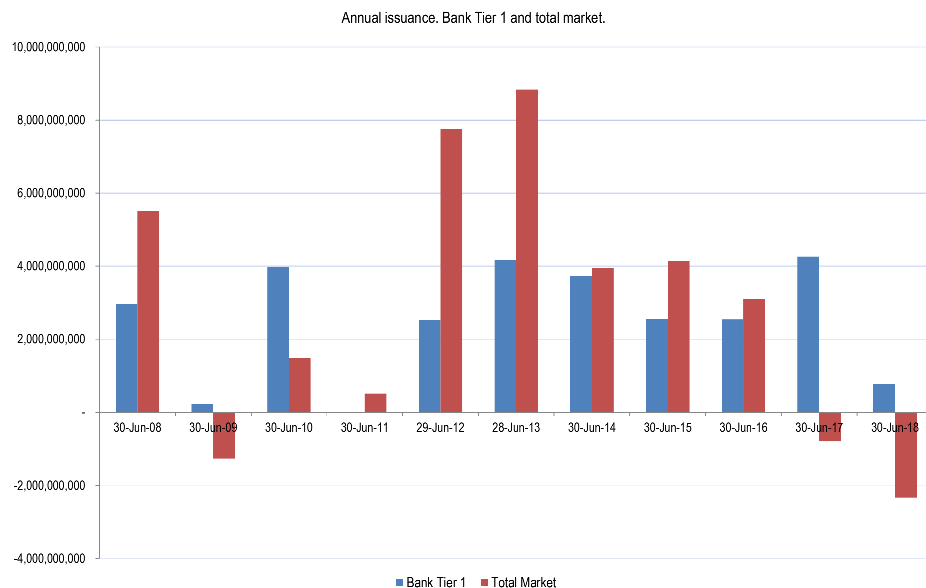


How does that impact AUD Hybrids?

We're heading into 2017/18 with reduced supply irrespective of what happens elsewhere in the world. The chart below shows the net issuance of all listed hybrids and the AT1 sub class. As the chart clearly shows we're coming off a prolonged period of large issuance to a prospective period of negative net new issuance. On current projections there will only be 2 issues by major banks in the next 12 months (ANZ & WBC replacing existing issues). If we see either;

- any one of the banks issuing offshore or
- local institutions continuing to buy hybrids in the primary and/or secondary market the probability of security prices falling is reduced materially. It's more likely they we'll see further capital appreciation.



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How far can they go?

We recognise that we are way beyond orthodoxy on where we think spread margins can end up, but bear with us for 100 words as we explain our thinking. The most interesting aspect is just what spread margin premium should bank capital securities command? A European CoCo issued by an "A" rated bank entity trades at a margin that is between "BB" and "B" rated corporate bonds. That's getting down to the junky end of the bond market where there is lots of default and event risk. Clearly, the market thinks either that the credit rating of the banks is overstated or that there are lots of other risks that investors need to be compensated for. We entirely agree that investors in bank securities need compensation for the "fat tails" that come with investing in a highly leverage entity. So we can understand the concerns, particularly given the inherent opacity of banks and the post GFC scars. But the last 5 years has seen the market proved wrong as the banks' credit ratings have roughly described their credit risk while the other risks didn't eventuate. Markets have been simply too pessimistic. The sectors s been considered ugly (and cheap) and it's due for a makeover.

So what could go wrong?

As the first chart shows despite a general downward trend towards the average, credit margins had some hiccoughs along the way. They fall into 3 broad categories;
- China is falling over (2014, 2016)
- Greece kills the Euro (2012, 2015)
- European banks kill Europe (2015, 2016).

We can't add any value on China and we think that Greece is either fully priced in or no longer relevant and as we explained above there is going to be much less hysteria about banks. Maybe there will be new and dangerous triggers, but it looks to us as though they won't be global bank specific. Clearly there will be headlines about Australian property prices, but we think the systemic risks for banks are not material. Home loan lending undertaken as little as 2 years ago has a large buffer due to property appreciation and more recent lending has largely been to investors (who have sufficient equity) and less than 80% LVR owner occupier (who have sufficient equity). Banks are at risk on >80% LVR loans written over the past 2 years however, these loans account for less than 10% of their new lending or around 2 or 3% of the total housing book. As with any of the past weakness, the equity market provides an incomplete but useful guide to hybrid prices. Regardless of our long term views, we'll continue our risk management practices and use equity prices as a guide to emerging risks.

What if APRA jacks up investor loan risk weightings?

It looks probable or possible that APRA (or Scott Morrison or the RBA? Who knows how these decisions are made?) will attempt to slow down investor lending by increasing the risk weighting on home loans. This will translate through to increased AT1 requirements of around $1.1b in total for all banks. By itself, this isn't enough to change our view, even if it does occur.

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