

Australian Debt & Hybrid Securities Research



Monthly Review April 2014

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Credit Analyst

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News and Outlook



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Government Bond & Money Markets

Interest-rate markets pushed out their expectations for any rate rises in 2014 following the weaker-than-expected inflation data for first-quarter 2014 and, in turn, the yield curve continues to flatten. The 10-year government bond dropped to a low of 3.92% on 28 April 2014 while long-term inflation expectations remained steady. This theme is unlikely to change in the near future as the economic data remains volatile. We continue to expect another leg up in the 10-year bond in late 2015 towards the long-term policy neutral rate (4.5% to 5.0%).

Credit

During the past few quarters, investors have witnessed equity markets rally and credit spreads compress to levels not seen since the financial crisis. While we remain comfortable with the credit profile of the majority of Australian issuers, all risk assets have a price and we caution investors not to fall into the trap of chasing yield at the expense of quality. At present we believe there is an imbalance in the listed fixed-income market whereby the insatiable demand for yield products significantly outweighs supply and hence, on aggregate, credit spreads are pushing the limit on fair value. It is difficult to see a catalyst for a change in direction for credit spreads in a very low default environment, but we believe that the risks in emerging markets have the propensity to spread to developed markets and therefore we remain conservative in our estimates.

Deposits & Official Cash Rate

On 1 April 2014, the Reserve Bank of Australia, or RBA, decided to leave the official cash rate unchanged at 2.50%. The theme was consistent with the previous month, suggesting that the most prudent course for monetary policy is likely to be a period of stability for interest rates. The key to the statement for us was that "monetary policy was appropriately configured to foster sustainable growth in demand and inflation outcomes consistent with the 2% to 3% inflation target.

Although we believe inflation is contained in the current environment the key to any inflation volatility remains the labour market. The recent spike in new full-time jobs is likely to put some steam under the inflation basket if the trend continues. However, in a seasonally strong quarter for inflation figures, the data for March 2014 was below expectations. Our broad thesis on inflation is that it will continue to rise over the medium term as the labour market

improves. This is predominantly because wages growth has been below trend during the past year, primarily as a result of labour market overcapacity. This overcapacity will reduce as business regains confidence in the broader macroeconomic environment. The problem in the short term is there a number of factors which could introduce noise into this trend (for example, fiscal tightening, China concerns).

Therefore, we continue to believe the official cash rate will remain on hold for the foreseeable future (that is, until end 2014). However, if the employment trend improves, we believe the core inflation data will rise and the RBA will be forced to look at moderating its neutral policy stance.

Economic Data

During the past month all domestic economic commentary has been focused on inflation. This commentary has been a result of criticism about the RBA's current neutral stance given the apparent increase in household wealth, food prices and the possibility of import-driven inflation. However, in the March 2014 quarterly CPI release, the data came in lower (0.6%) than market and RBA expectations - these expectations were adjusted following the 0.9% jump for the December quarter. Even though the March data was lower than expected, we believe inflation will continue to track higher. The headline inflation rate has risen from a low of 1.2% annualised in June 2012, to 2.9% annualised (the underlying rate has risen from a low of 1.9% to 2.7%) in March 2014. But this momentum occurred when wages growth was trending down to its current historical low. This effectively means we are not seeing cost-push inflation but demand-pull inflation and any improvement in the labour market will result in inflation increasing further.

Technical

Market technicals are an important topic at present as corporate fundamentals remain stable but credit spreads continue to tighten. For retail investors there are two technical influences to be aware of:

- The current monetary policies of developed nations is consistent with a recessionary environment (zero interest-rate policy), however the U.S. economy and global credit market valuations are at more advanced stages of recovery and expansion. A change in policy will bring with it reduced liquidity which is likely to lead to a correction in prices across all markets.
- During the past few years, primary issuance in the listed interest-rate security market has been well above trend as

the self-managed super fund sector has sought to satisfy its appetite for yield-based products. This demand has not changed in the past six months which has been evident in the scaling back of allocations in ANZPE and SUNPE. The problem is new issuance has slowed significantly as the corporate sector remains closed and the banks have matched the majority of their requirement for additional tier-1 capital. This puts pressure on the secondary market (which at the best of times is illiquid) and hence the prices increase and credit spreads tighten.

As we have said previously, many credit securities are now back near 2007 spread levels which arguably underestimates the potential for increased interest-rate volatility. The listed interest-rate security market maintains an asymmetric return profile but we still consider it a reasonable place to be in the current environment (short duration and strong bank credit quality).

International Markets

In the U.S. there has been a lack of new issue supply during the past few weeks which has created an imbalance between demand and supply. Our U.S. colleagues expect that the new issue supply will increase during coming months as numerous companies exit their quiet periods after their earnings releases, which should ease some pressure and keep credit spreads at current levels. But if the new issue market does not pick up, then we expect spreads to grind tighter in the near term.

China delivered more soft economic data during the month, with first-quarter GDP showing a 7.4% growth rate (one of the two lowest rates of the past two years). However, the expectations were low (7.3%) and therefore emerging markets

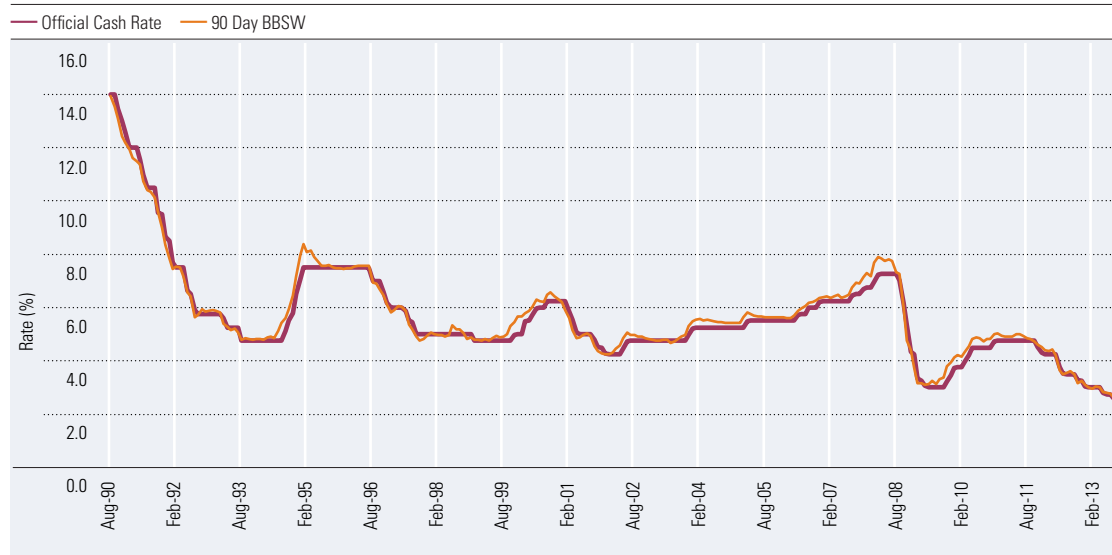
had a small relief rally. Our U.S. economist continues to believe the Chinese economy is yet to experience a low in its economic output, and will keep a close eye on Markit purchasing managers' data for further clues.

Recommendation Changes Since Last Month

- On 14 March 2014, we updated our recommendation on TAHHB. Results were broadly in line with expectations but the earnings risk in the wagering business is becoming ever more apparent. We maintain a medium risk assessment of the issuer but are cautious there is very little headroom for debt-funded capital expenditure.
- On 14 March 2014, we updated our recommendation on ANZPE. ANZPE is looking expensive on valuation grounds but on a relative basis spreads across the sector have compressed. We remain comfortable with the credit profile of Australia & New Zealand Banking Group and we initiate with a Hold recommendation.
- On 14 March 2014, we updated our recommendation on ORGHA. Although we believe in the economic merits of the Australia Pacific Liquefied Natural Gas, or APLNG, project we remain concerned that Origin has not been more conservative with its capital management during the past few years given the significant amount of debt drawn to fund APLNG capital commitments. The project finance facility is effectively fully drawn which means, to project completion, Origin is committed to providing 37.5% of the capital directly. Although we know the company has more than sufficient facilities available to meet this requirement, it's possible this will be at the expense of ORGHA securityholders. The current trading margin does not reflect the potential for extension risk and we reduce our recommendation from Hold to Sell. ■■■

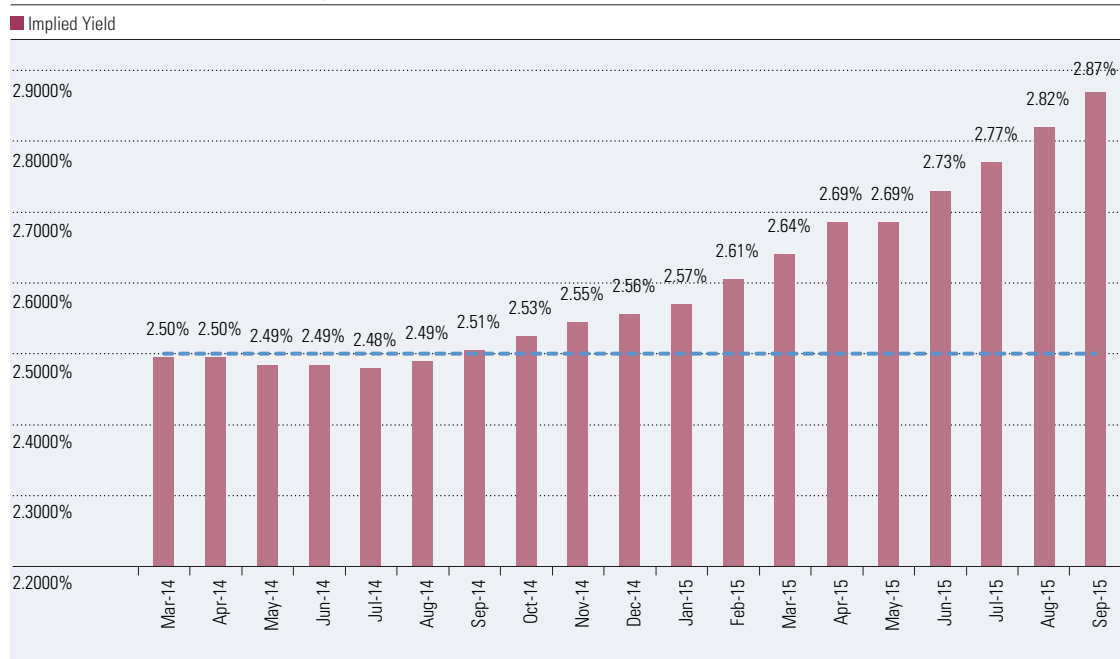
Chart Pack

Figure 1: 90-Day Bank Bills vs Official Cash Rate



Source: Morningstar, Reserve Bank of Australia

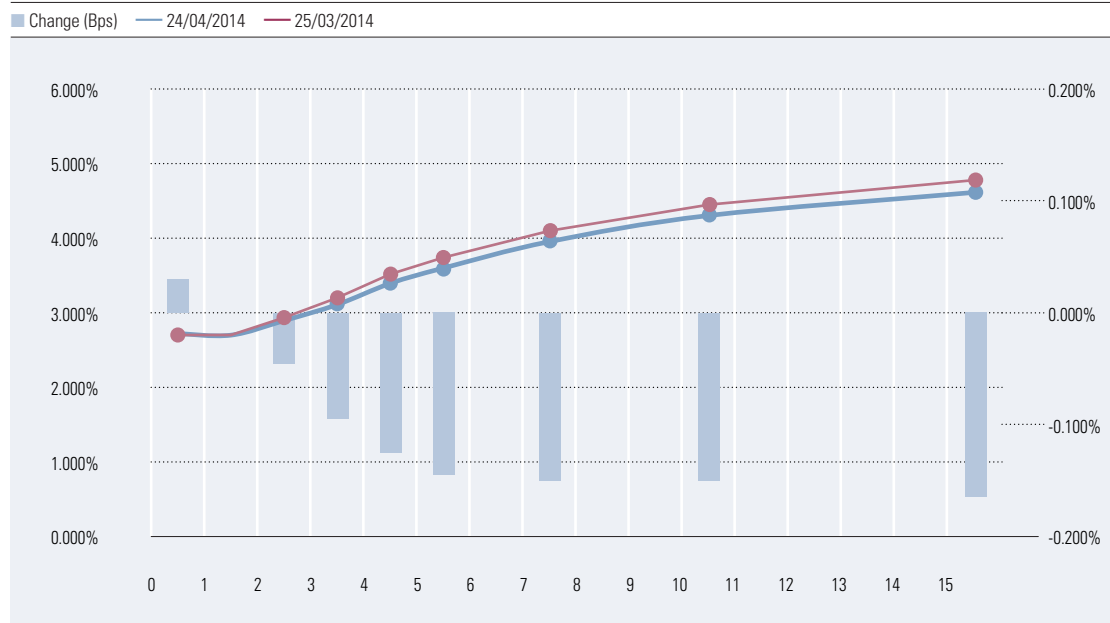
Figure 2: Interest Rate Futures Implied Cash Rate



Source: ASX

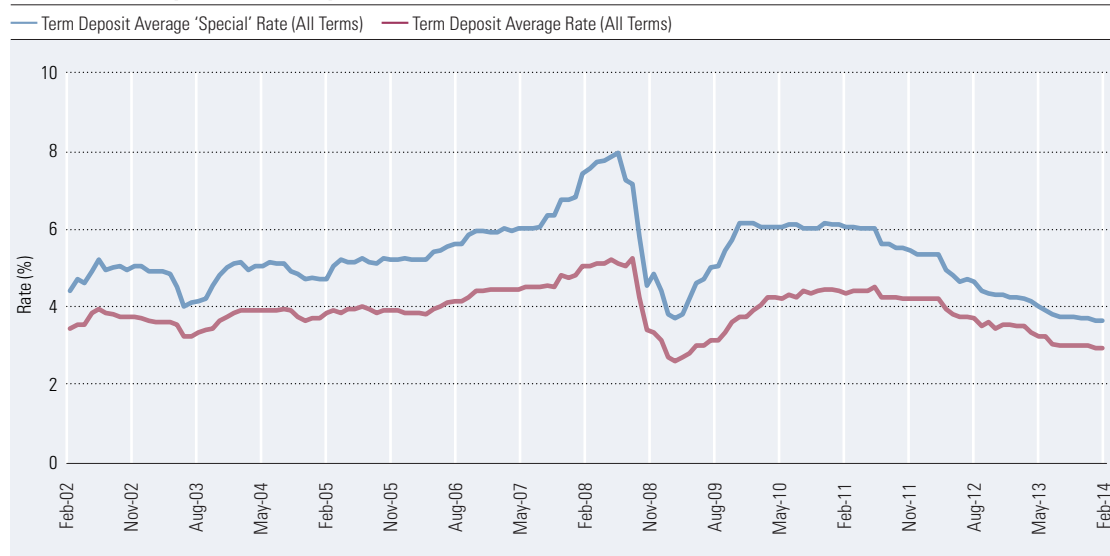
Chart Pack

Figure 3: Money Market Curve (Interest Rate Swaps)



Source: AFMA

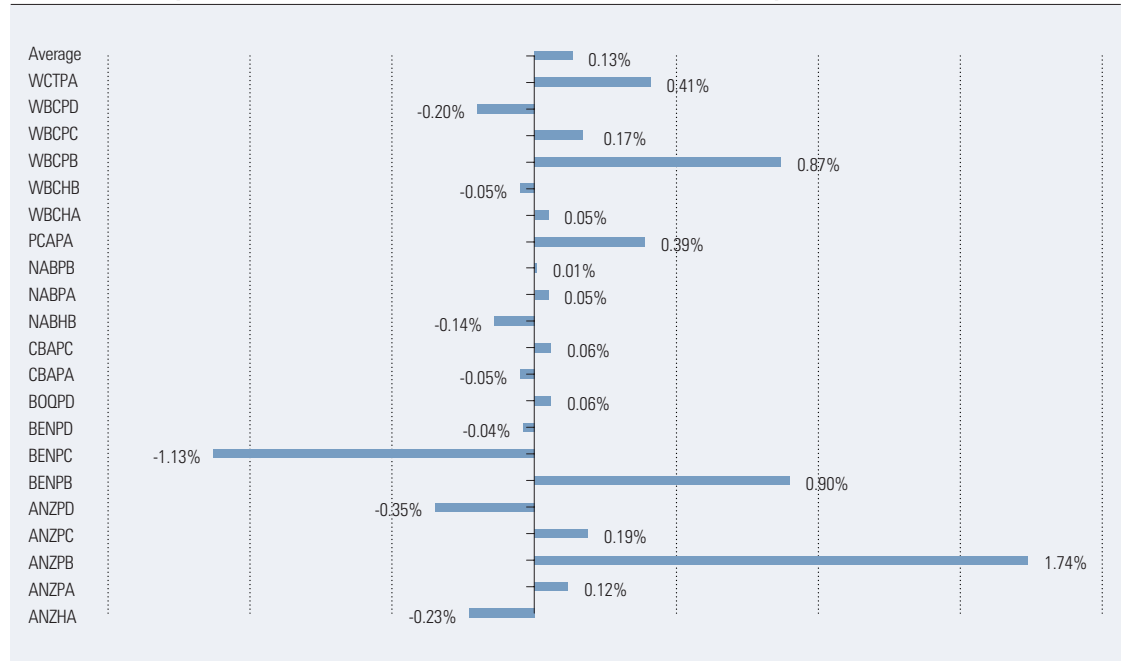
Figure 4: Term Deposit Average 'Special' Rate (All Terms)



Source: Reserve Bank of Australia

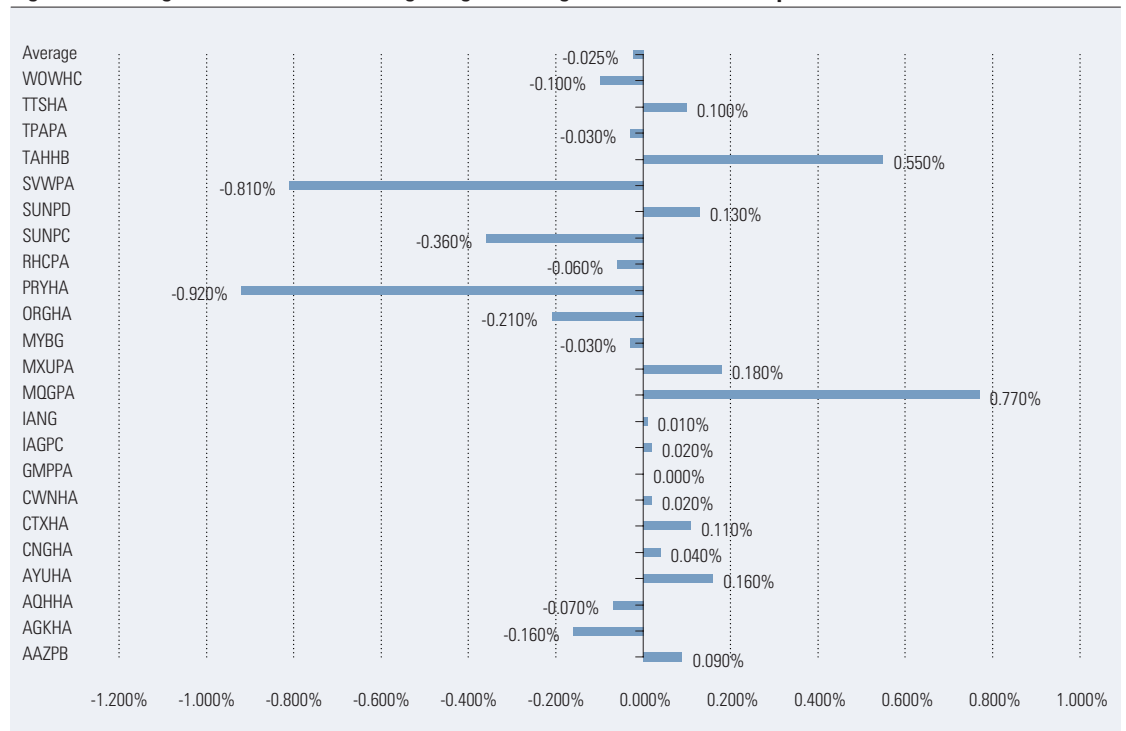
Chart Pack

Figure 5: Bank Capital Securities – Trading Margins (change on month) as at 28 April 2014



Source: Morningstar

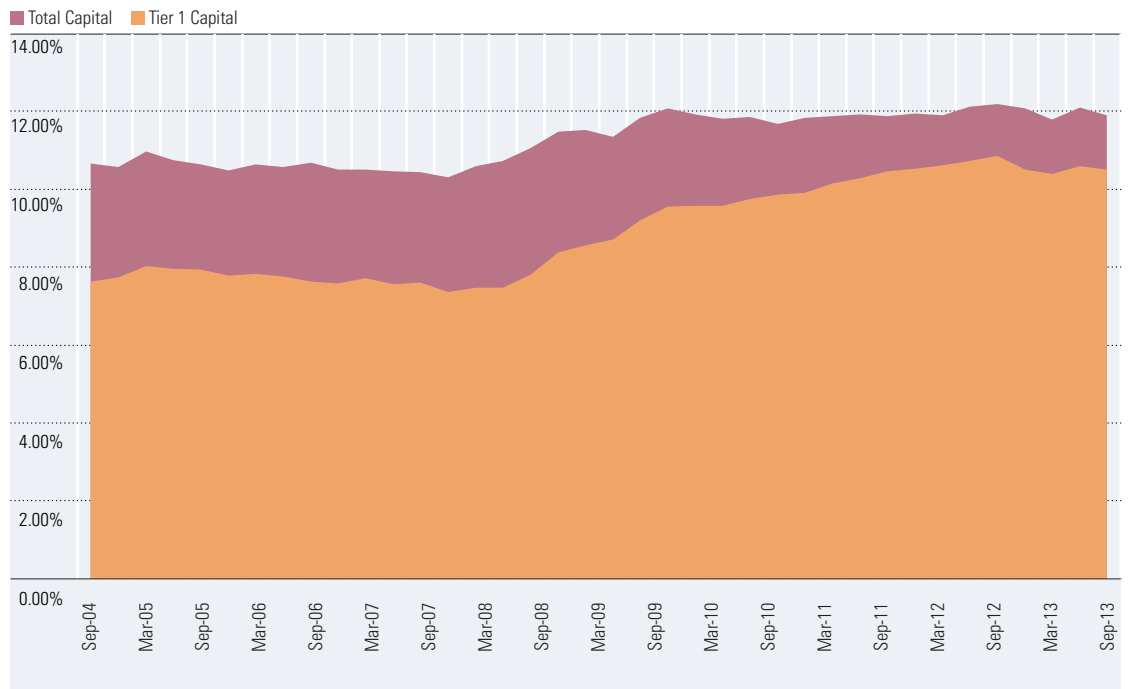
Figure 6: Floating Rate Securities – Trading Margins (change on month) as at 28 April 2014



Source: Morningstar

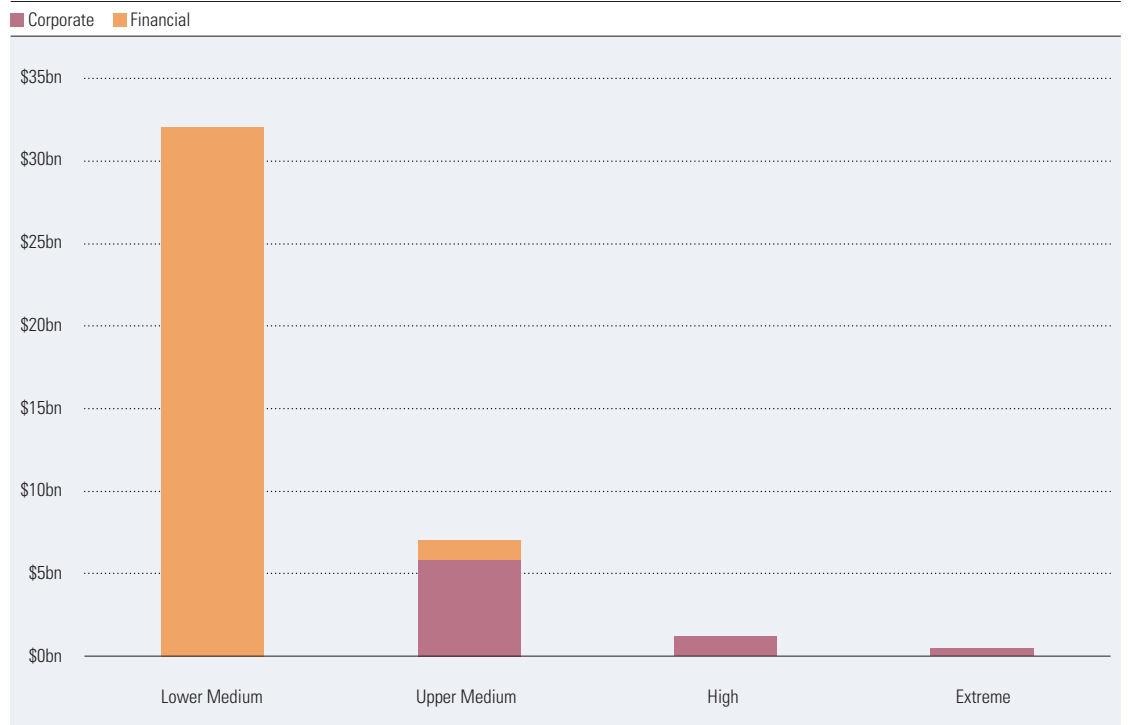
Chart Pack

Figure 7: Australian Bank Capital Components



Source: APRA

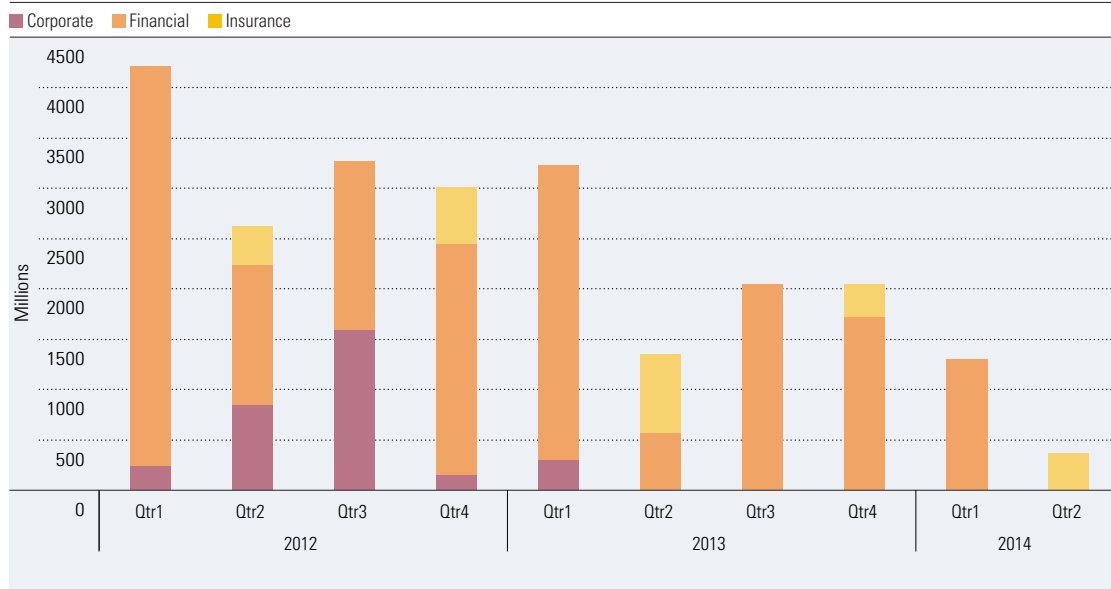
Figure 8: Market Issuance by Issuer Risk Bucket



Source: Morningstar

Chart Pack

Figure 9: New Issuer Monitor



Source: Morningstar

Appendix A: Security Recommendations as at 28/04/2014

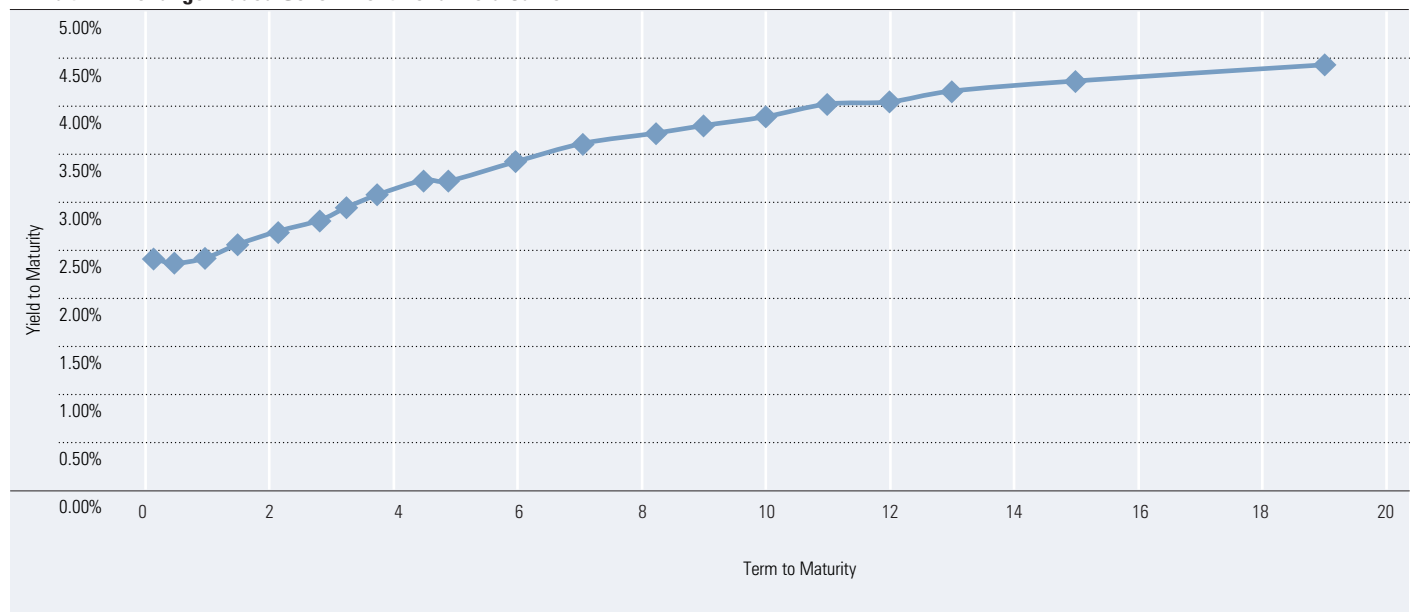
Code	Recommendation	Price (AUD)	Issuer	Issue Size (AUD m)	Years To Maturity	Trading Margin	Running Yield		Yield to Reset		Dist (AUD)	Ex Date
							inc Fr	ex Fr	inc Fr	ex Fr		
AGKHA	Hold	106.19	AGK	650.00	5.11	2.65%	6.34%	6.34%	5.44%	5.44%	1.62	30/05/2014
AMPHA	Hold	101.85	AMP	325.00	4.64	2.35%	5.42%	5.42%	5.16%	5.16%	1.33	5/06/2014
ANZHA	Accumulate	103.90	ANZ	1508.65	3.13	1.69%	5.40%	5.40%	4.43%	4.43%	1.36	10/06/2014
ANZPA	Accumulate	102.20	ANZ	1970.00	2.63	2.52%	5.87%	4.11%	5.31%	3.44%	1.00	27/05/2014
ANZPB	Accumulate	100.30	ANZ	1081.21	0.13	3.83%	5.35%	3.75%	8.07%	4.88%	0.90	27/05/2014
ANZPC	Accumulate	101.50	ANZ	1340.00	3.35	2.91%	5.94%	4.16%	5.75%	3.87%	2.00	13/08/2014
ANZPD	Hold	102.75	ANZ	1120.00	7.35	3.10%	6.17%	4.32%	5.95%	4.03%	2.11	20/08/2014
ANZPE	Hold	101.27	ANZ	1610.00	7.91	3.14%	6.08%	4.26%	6.00%	4.13%	2.03	12/09/2014
AQHHA	Hold	106.00	APA	515.00	3.92	2.98%	7.04%	7.04%	5.78%	5.78%	1.78	18/06/2014
CBAHA	Hold	100.01	CBA	575.00	1.65	1.13%	3.83%	3.83%	3.91%	3.91%	0.94	3/07/2014
CBAPA	Accumulate	202.70	CBA	2000.00	0.51	0.61%	6.18%	4.33%	3.43%	1.59%	2.06	15/01/2014
CBAPC	Hold	104.23	CBA	2000.00	4.63	2.97%	6.46%	4.52%	5.79%	3.75%	1.14	4/06/2014
CNGHA	Hold	102.95	CBA	1000.00	2.92	2.36%	5.96%	5.96%	5.15%	5.15%	1.50	18/06/2014
CTXHA	Hold	107.90	CTX	550.00	3.38	2.31%	6.93%	6.93%	5.04%	5.04%	1.78	4/06/2014
CWNHA	Hold	108.00	CWN	531.97	4.38	3.22%	7.42%	7.42%	6.01%	6.01%	1.97	4/06/2014
GMPPA	Hold	100.40	GMG	326.97	3.68	3.94%	6.81%	6.81%	6.82%	6.82%	1.60	15/06/2014
IAGPC	Hold	104.17	IAG	377.37	3.01	2.46%	6.62%	4.64%	5.31%	3.29%	2.30	18/10/2014
IANG	Hold	105.90	IAG	550.00	5.64	2.96%	6.56%	4.59%	5.78%	3.70%	1.16	4/06/2014
MBLHB	Accumulate	84.50	MQG	400.00	-	2.54%	5.35%	5.35%	-	-	1.10	26/06/2014
MQGPA	Hold	104.88	MQG	600.00	4.14	3.43%	6.74%	4.72%	6.23%	3.97%	2.92	23/5/2014
NABHA	Accumulate	77.95	NAB	2000.00	-	2.38%	5.18%	5.18%	-	-	0.94	28/04/2014
NABHB	Accumulate	104.00	NAB	1172.51	3.14	1.63%	5.40%	5.40%	4.38%	4.38%	1.36	5/06/2014
NABPA	Accumulate	101.78	NAB	1541.33	4.89	2.94%	6.00%	4.20%	5.77%	3.90%	1.03	2/06/2014
NABPB	Hold	102.30	NAB	1717.19	6.64	2.96%	6.02%	4.21%	5.80%	3.92%	1.04	28/05/2014
ORGHA	Reduce	103.65	ORG	900.00	2.65	2.84%	6.70%	6.70%	5.62%	5.62%	1.66	11/06/2014
PCAPA	Accumulate	193.60	CBA	1166.46	1.94	2.88%	3.96%	2.77%	5.77%	4.53%	1.31	26/06/2014
RHCPA	Hold	106.50	RHC	260.00	-	4.43%	7.33%	5.13%	-	-	2.62	7/10/2014
SUNPC	Hold	105.68	SUN	560.00	3.64	3.21%	7.23%	5.06%	6.01%	3.71%	1.29	5/06/2014
SUNPD	Hold	103.15	SUN	770.00	4.57	2.35%	5.57%	5.57%	5.13%	5.13%	1.31	12/05/2014
SVWPA	Hold	89.01	SVW	496.36	-	6.01%	8.98%	6.29%	-	-	2.64	15/5/2014
TAHHA	Hold	105.44	TAH	250.00	2.90	2.29%	6.58%	6.58%	5.04%	5.04%	1.66	11/06/2014
TTSHA	Hold	104.60	TTS	194.66	5.19	2.21%	5.70%	5.70%	4.98%	4.98%	1.44	25/06/2014
WBCHA	Accumulate	104.10	WBC	1676.22	3.32	1.80%	5.41%	5.41%	4.52%	4.52%	1.31	13/05/2014
WBCHB	Hold	101.70	WBC	925.28	4.32	2.11%	5.08%	5.08%	4.89%	4.89%	1.20	12/05/2014
WBPCB	Accumulate	101.99	WBC	908.33	0.42	0.84%	6.59%	4.61%	3.04%	0.71%	1.13	18/06/2014
WBPCP	Accumulate	101.66	WBC	1189.36	3.92	2.91%	6.05%	4.23%	5.76%	3.88%	2.09	18/09/2014
WBPCPD	Hold	102.85	WBC	1383.57	4.86	2.74%	5.94%	4.16%	5.55%	3.68%	1.03	28/05/2014
WCTPA	Accumulate	96.51	WBC	762.74	2.17	2.80%	3.93%	2.75%	5.70%	4.47%	0.64	11/06/2014

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Appendix B: Exchange Traded Australian Government Bonds as at 28/04/14

ASX Code	Price	Coupon	Ex-date	Payment Date	Running Yield	YTM	Maturity
GSBK14	102.795	6.25%	4-Jun-14	16-Jun-14	6.08%	2.42%	15-Jun-14
GSBS14	100.962	4.50%	9-Oct-14	22-Apr-14	4.46%	2.37%	15-Oct-14
GSBG15	103.818	6.25%	2-Oct-14	15-Apr-14	6.02%	2.42%	15-Apr-15
GSBS15	103.26	4.75%	9-Oct-14	22-Apr-14	4.60%	2.56%	21-Oct-15
GSBK16	105.975	4.75%	4-Jun-14	16-Jun-14	4.48%	2.70%	15-Jun-16
GSBC17	109.591	6.00%	5-Aug-14	17-Feb-14	5.47%	2.82%	15-Feb-17
GSBM17	105.085	4.25%	9-Jul-14	21-Jul-14	4.04%	2.95%	21-Jul-17
GSBA18	109.819	5.50%	9-Jul-14	21-Jul-14	5.01%	3.08%	21-Jan-18
GSBS18	99.999	3.25%	9-Oct-14	22-Apr-14	3.25%	3.23%	21-Oct-18
GSBE19	109.503	5.25%	3-Sep-14	17-Mar-14	4.79%	3.22%	15-Mar-19
GSBG20	105.588	4.50%	2-Oct-14	15-May-14	4.26%	3.43%	15-Apr-20
GSBI21	115.607	5.75%	5-May-14	15-May-14	4.97%	3.62%	15-May-21
GSBM22	115.45	5.75%	3-Jul-14	15-Jul-14	4.98%	3.72%	15-Jul-22
GSBG23	112.637	5.50%	9-Oct-14	22-Apr-14	4.88%	3.80%	21-Apr-23
GSBG24	90.388	2.75%	9-Oct-14	22-Apr-14	3.04%	3.89%	21-Apr-24
GSBG25	93.04	3.25%	9-Oct-14	22-Apr-14	3.49%	4.02%	21-Apr-25
GSBG26	101.45	4.25%	9-Oct-14	22-Apr-14	4.19%	4.05%	21-Apr-26
GSBG27	105.721	4.75%	9-Oct-14	22-Apr-14	4.49%	4.16%	21-Apr-27
GSBG29	88.521	3.25%	9-Oct-14	22-Apr-14	3.67%	4.26%	21-Apr-29
GSBG33	100.38	4.50%	9-Oct-14	22-Apr-14	4.48%	4.43%	21-Apr-33

Exhibit 11: Exchange Traded Government Bond Yield Curve

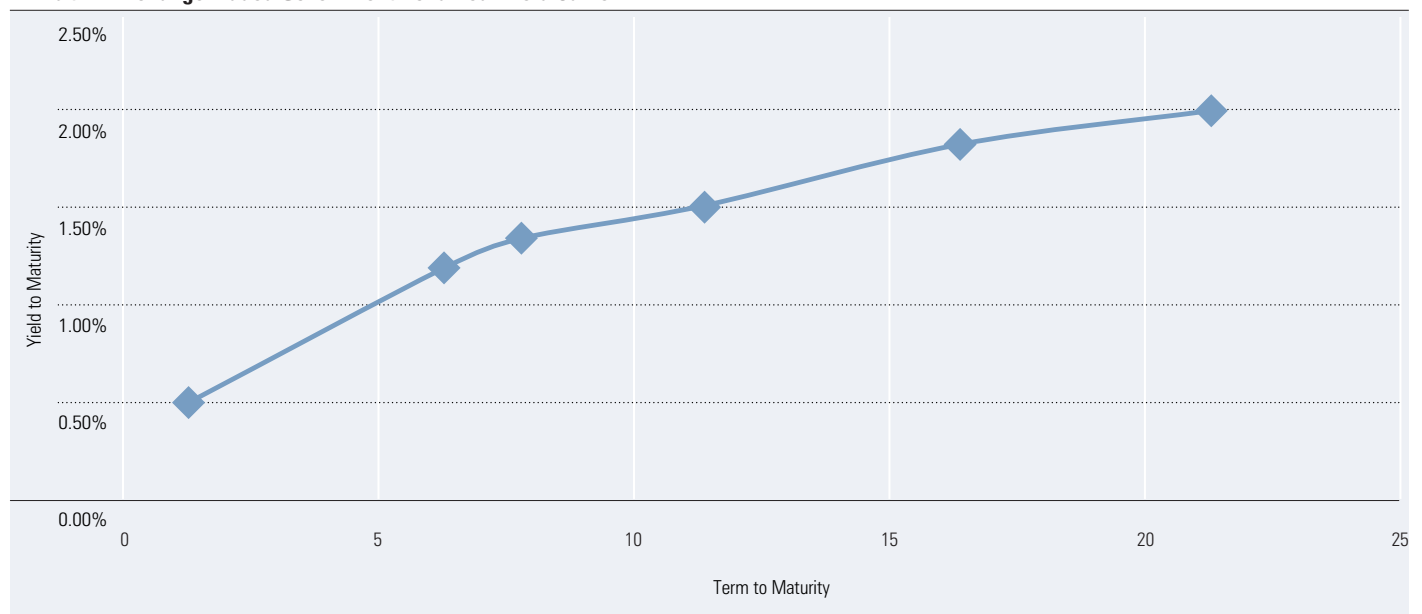


Source: ASX, Morningstar

Appendix C: Exchange-traded Treasury Indexed Bonds ("eTIB") as at 28/04/14

ASX Code	Price	Coupon	Ex-date	Payment Date	Running Yield	YTM	Maturity
GSI015	179.85	4.00%	8-May-14	20-Feb-14	2.224%	0.500%	20-Aug-15
GSI020	186.639	4.00%	8-May-14	20-Feb-14	2.143%	1.190%	20-Aug-20
GSI022	104.420	1.25%	9-May-14	21-Feb-14	1.197%	1.341%	21-Feb-22
GSI025	130.002	3.00%	10-Jun-14	20-Mar-14	2.308%	1.509%	20-Sep-25
GSI030	120.240	2.50%	10-Jun-14	20-Mar-14	2.079%	1.822%	20-Sep-30
GSI035	102.700	2.00%	9-May-14	21-Feb-14	1.947%	1.995%	21-Aug-35

Exhibit 12: Exchange Traded Government Bond Real Yield Curve

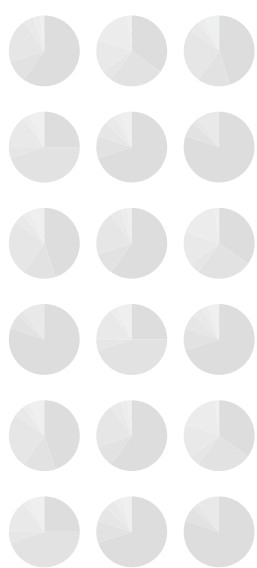


Source: ASX, Morningstar

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	<p>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:</p> $\text{Conversion Number} = \text{Face Value} / [\text{VWAP} \times (1 - \text{Conversion Discount})]$
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	<p>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.</p> <p>In tables and abbreviations, we use "Reset" to refer to any step-up, mandatory conversion, call or other pseudo-maturity event.</p>
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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