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INSIGHT

# Cash in a post COVID-19 world

Short-term money markets experienced extreme COVID-19 related illiquidity in early March, prompting a swift package of policy measures from the Reserve Bank of Australia (RBA). Whilst this policy action was effective in calming markets and restoring confidence, it has also altered the way in which short-term interest rate markets are functioning.

**by Kashi Trathen and Jo Niall**

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DEBT INVESTMENTS

A shift in the supply and demand for various money market securities has occurred and this is creating new relationships between markets, such as the Bank Bill Swap Rate/ Overnight Indexed Swap (BBSW/OIS) spread turning negative for the first time in history, the overnight cash rate persistently trading below the official cash rate and a significant contraction in both supply and demand within the Floating Rate Note (FRN) market.

With interest rates set to remain very low (or even negative), these new relationships are likely to persist for some time and they may have implications for how trustees manage their cash portfolios in future. In particular, we believe trustees should diversify their holdings to include securities such as Treasury Notes, and consider investing in offshore cash markets. Global cash can offer a broader liquidity pool and may allow investors to take advantage of periodic episodes of extreme relative value opportunities due to moves in the cross currency basis.

## The RBA term funding facility: a brief overview

The Term Funding Facility (TFF) was announced by the RBA on 19 March as part of a package of measures to support market liquidity and the real economy during the COVID-19 crisis. This facility, in which banks deliver eligible collateral to the RBA, provides three-year funding to Authorised Deposit-taking Institutions (ADIs) at a rate of 0.25 per cent. The TFF is designed to incentivise lending to small and medium sized enterprises (SMEs) affected by COVID-19 related economic shutdowns.

The total volume of the TFF allowance allocated to a particular institution consists of an initial allowance and an additional allowance as detailed in Figure 1. The initial allowance is set at three per cent of the participant's total credit outstanding to Australian resident households and businesses in the three months to 31 January 2020.

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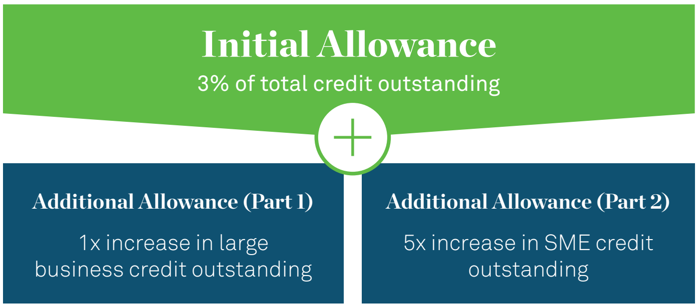
FIGURE 01 RBA TERM FUNDING FACILITY ALLOWANCES




**Source:** IFM Investors, Reserve Bank of Australia

The additional allowance is the sum of the increase to large business credit outstanding plus five times the increase to SME credit outstanding, assessed monthly[1]. In other words, banks that focus their lending on small businesses will receive a large volume of cheap funding. It remains to be seen what effect this will have on bank lending behaviour and credit standards.

The good news for banks doesn't stop there. On 30 March, APRA advised that it would allow ADIs to include the benefit of the TFF initial allowance in the calculation of the Liquidity Coverage Ratio and Net Stable Funding Ratio[2]. This will result in an improvement to these liquidity ratios, and will reduce the need for banks to issue securities such as notice deposit accounts, which were designed to meet these regulatory requirements. Indeed IFM Investors has already seen margins for these products decline, and this is likely to continue.

> **We believe the TFF will lead to tighter credit spreads and lower yields in cash portfolios by suppressing bank funding costs.**
>
> Kashi Trathen

Overall, we believe the TFF will lead to tighter credit spreads and lower yields in cash portfolios by suppressing bank funding costs. It will also likely result in an increase to exchange settlement account balances, which is discussed in more detail later in this paper.

## RBA yield curve control will aim to keep bond markets liquid

The RBA also announced that it would purchase government bonds, with the aim of achieving a three-year yield target of 0.25 percent[3]. This is known as yield curve control (YCC). It was subsequently revealed that this programme would also include both government and semi-government bonds with maturities ranging from 2021-2030. As of 29 April, total RBA bond purchases amounted to just over $50 billion[4] (see Figure 2 on page 3).

This YCC programme had several effects:

1. The dramatic volatility witnessed in fixed income markets in March was reduced;
2. Fixed income and money market liquidity returned to more normal levels;
3. Forward guidance regarding the path of future interest rates was reinforced - the RBA will not be increasing the targeted cash rate anytime soon;
4. Funding costs for state governments and the private sector will likely be reduced over the medium term.

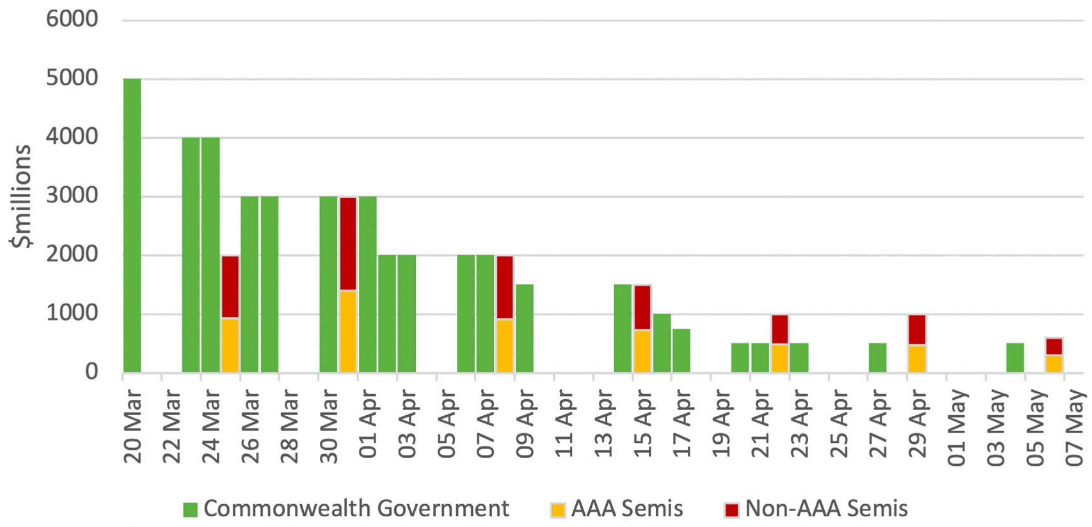
So what does this mean for cash investors? Simply put, it means very low interest rates for the foreseeable future. In the next section we look at how this is affecting money market interest rates.

## BBSW is setting below OIS, and this is likely to persist

Money market spreads widened in mid-March, as funds sold short-term interest rate securities in response to perceived liquidity concerns as well as uncertainty around the economic implications of COVID-19. In what represents an extraordinarily rapid turnaround, less than a month later, BBSW/OIS spreads have turned negative for the first time in history[5] as shown in Figure 3.

[1] For a detailed explanation of how this works, please refer to the RBA announcement: https://www.rba.gov.au/mkt-operations/term-funding-facility/announcement.html
[2] APRA press release: https://www.apra.gov.au/news-and-publications/apra-advises-regulatory-approach-to-rba-term-funding-facility
[3] RBA Announcement: Reserve Bank Purchases of Government Securities https://rba.gov.au/mkt-operations/announcements/rba-purchases-of-government-securities.html
[4] Source: Reserve Bank of Australia, Bloomberg.
[5] The spread between the BBSW and OIS is usually a good indicator of the health of the banking system and the preparedness for banks to extend credit to one-another.

FIGURE 02 RBA DAILY BOND PURCHASES SINCE MARCH 2020




**Source:** Reserve Bank of Australia, May 2020

FIGURE 03 BBSW/OIS SPREADS


**Source:** Bloomberg, ASX, May 2020

It is our observation that the RBA's measures to improve liquidity and support the economy, combined with pre-emptive liquidity accumulation by superannuation funds, have altered the supply-demand balance for short-term money market securities.

On the supply side, banks now have ample access to relatively cheap funding due to larger than normal volumes of RBA open market operations (OMO) as well as the TFF. This is likely to displace the need for short-term wholesale issuance, particularly given that only a very small percentage of the total TFF allowance has been utilised thus far.

On the demand side, many superannuation funds appear to be holding larger than normal cash balances to respond to member withdrawals following federal government policy to allow individuals early access to up to $20,000 of superannuation in certain circumstances.

The continued narrowing of spreads is occurring despite what we consider to be poor macroeconomic and credit risk fundamentals. Anecdotally, Westpac credit spreads continued to contract following the 28 April announcement of a $2.1 billion impairment charge. We expect BBSW/OIS spreads to remain negative and margins on short-dated major bank FRNs to stay compressed at low levels for as long as these new supply-demand conditions remain in place. It will be particularly important to observe any changes in the loan to deposit ratio in coming months. Falling deposit growth is traditionally associated with widening BBSW/OIS spreads.

In the next section, we look at why OIS itself is below the cash rate, even though we believe further cuts to the official cash rate are unlikely in the near-term.

## The RBA overnight cash rate is lower than the official cash rate target

Higher than normal Exchange Settlement Account (ESA) balances with the RBA have reduced the overnight cash rate to below the official cash rate target (OCR).

Banks and other institutions hold ESAs with the RBA in order to facilitate the settlement of obligations between each other. The interest rate accrued on these accounts depends on the size of the balance. For example, banks have required ES balances, on which they earn a rate equal to the official cash rate target

(OCR). Balances above this amount ('excess balances') earn 15 basis points below target (currently 0.10%)[6].

ES balances are determined by transactions between the RBA and ES account holders. Traditionally, the RBA undertook sufficient reverse repo transactions (open market operations) to ensure that the cash rate remained equal to OCR. Recently, RBA transactions with ES account holders have resulted in higher ES balances. There are several reasons for this, but we see two key drivers:

1. Since 19 March, the total volume of reverse repo transactions undertaken by the RBA has increased in order to provide liquidity to the financial system as shown in Figure 4. Specifically, the central bank committed to providing one and three-month term repo liquidity on a daily basis.
2. The RBA began to purchase government bonds as part of its YCC programme.

The net impact of these actions (as well as some other factors beyond the scope of this paper) has been a dramatic increase in bank ES balances, resulting in an average overnight cash rate that is below the OCR target.

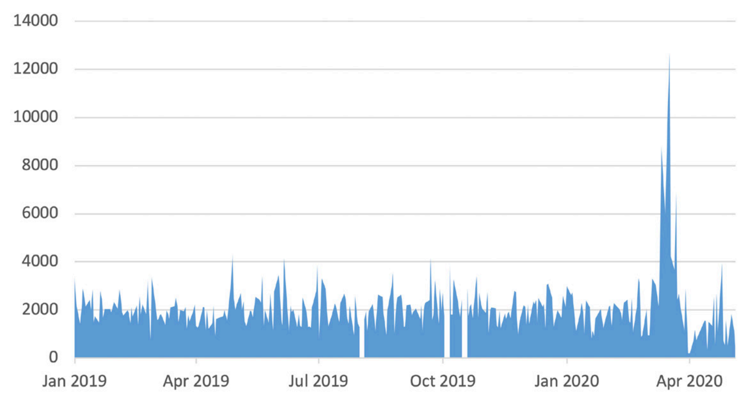
In short – the RBA has, through its policy settings, decreased the OCR without announcing it, and this has dragged other interest rates, such as BBSW, lower too.

In the near future, continued government bond purchases by the RBA, as well as the utilisation of the TFF by banks, will likely result in further increases to ES balances. However as money markets normalise, these factors could be offset by a reduction in open market operations by the RBA, which may serve to provide less liquidity to the repo market, thereby reducing the ES balances. The overnight cash rate will be determined by the balance of these factors, and is therefore likely to remain below 0.25 per cent in the near term[7].

## There will likely be less demand for FRNs, but even less supply

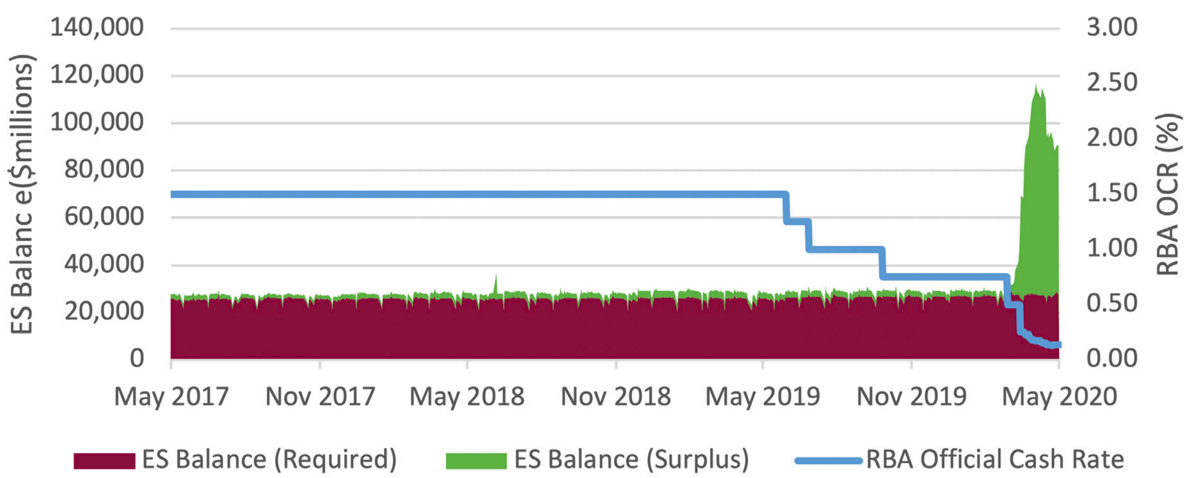
Many cash investors were understandably discouraged by the extreme illiquidity and sharp widening in credit spreads in the short dated FRN market in March, and it is likely that some funds will avoid purchasing them in the future[8]. Furthermore, given the poor macroeconomic backdrop and the risk

**FIGURE 04** RBA DAILY OPEN MARKET OPERATIONS VOLUMES ($M)




**Source:** RBA, May 2020

**FIGURE 05** ESA BALANCES AND THE RBA OVERNIGHT CASH RATE




**Source:** Reserve Bank of Australia https://www.rba.gov.au/mkt-operations/resources/statistics.html, May 2020

[6] Note that prior to 20th March, excess balances would earn 25 basis points below OCR. For a detailed explanation of ESA interest rate calculations, please refer to this publication from the RBA: https://www.rba.gov.au/rits/info/pdf/ESA_Interest_Rates.pdf)
[7] RBA exchange settlement account policy: https://www.rba.gov.au/payments-and-infrastructure/esa/
[8] For a detailed description of what occurred in March, please read our previous paper titled "March madness in money markets", Kashi Trathen, May 2020.

of a second wave of COVID-19 infections in the northern hemisphere, investors ought to remain cautious when purchasing any credit spread product. Both these factors suggest demand for FRNs is likely to be lower in coming months.

However, we believe that this reduced demand will be more than offset by reduced supply, as banks continue to rely on the TFF as a source of cheap funding, and higher volumes of RBA repo activity make a repeat of the extreme liquidity conditions unlikely. Furthermore, in early May, the RBA announced that investment grade corporate credit, of which bank FRNs are a subset, will now be repo-eligible. This could make it easier for bank traders to hold this paper, preventing the kind of precipitous spread-widening and illiquidity seen in March. Higher than normal cash allocations and the search for yield in a near zero interest rate environment are also likely to cushion the impact of decisions by some funds to cease investing in FRNs. We therefore believe that short dated FRN spreads are likely to narrow further from current levels.

**FIGURE 06** EXTREME LEVELS IN CROSS CURRENCY BASIS CAN CREATE RELATIVE VALUE OPPORTUNITIES FOR INVESTORS


**Source:** Bloomberg, May 2020

> **IFM Investors has argued that global cash could offer a broader liquidity pool.**
>
> Kashi Trathen

## Global money markets can provide liquidity and higher yields

As Australian funds have globalised their equity and bond investments, cash has remained locally invested in the Australian money markets. For some time, IFM Investors has argued that global cash could offer a broader liquidity pool, and allow investors to take advantage of periodic episodes of extreme relative value opportunities due to moves in the cross currency basis.

Australian banks source some of their funding from global short-term money markets. Historically, this has created a strong correlation between the pricing of fully hedged US dollar (USD) funding (swapped back to AUD) and the pricing of domestic funding.

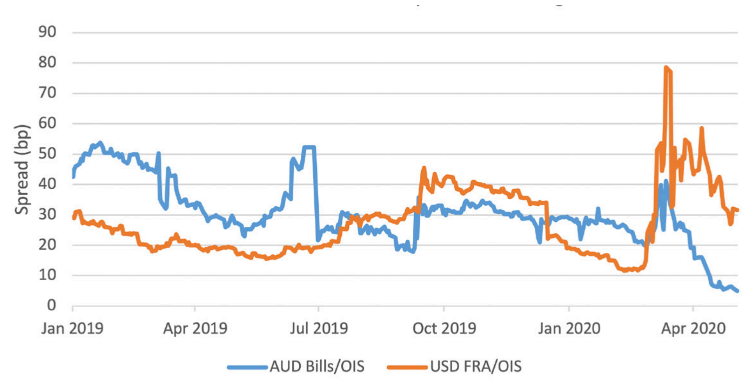
The three month AUD cross currency basis moved to all-time highs in March (see Figure 6). At that point in time, an Australian investor could have purchased 6-month major bank FRNs in the USD market hedged back to AUD for an all in yield of 3 month BBSW + 130 bp[9]. Moreover, attractive levels had persisted well after domestic Australian FRN spreads had narrowed from their widest levels. Normally we would expect AUD paper to widen along with USD spreads, however this isn't happening at present.

There are a number of potential explanations for why Australian and US spreads are dislocated from each other:

1. Suppressed credit demand from business and retail borrowers means that Australian banks have little need for funding at the present time, so there is very little supply of new issuance.
2. Access to relatively cheap funding via the RBA's TFF displaces the need to fund via the wholesale market.
3. USD FRA/OIS spreads widened significantly, while AUD BBSW/OIS spreads narrowed as shown in Figure 7. The cross currency basis differential captures this discrepancy which has become larger as a result of these market moves.
4. Australian banks were already well funded going into March and have likely seen increased retail deposits in the past month as risk averse retail investors have sold down their equity positions (similar to what was observed in the wholesale market).

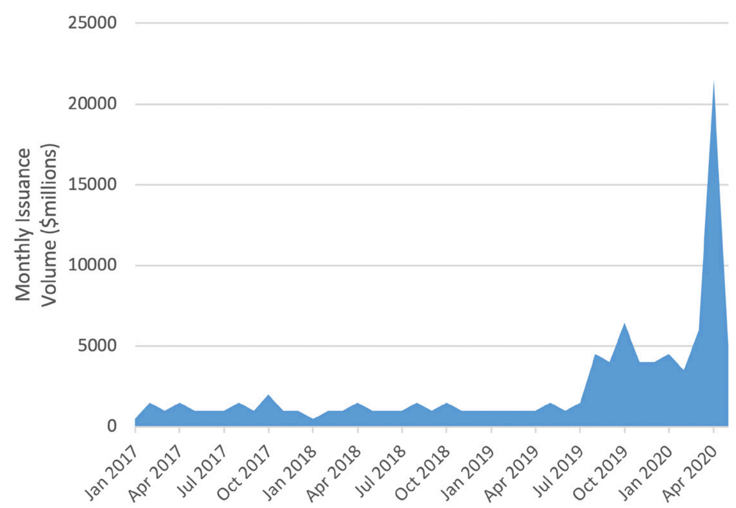
[9] For illustrative purposes only and should not be construed as investment advice or a recommendation to invest in any securities. There is no guarantee that the same or similar investment opportunities will be available at any point in time.

**FIGURE 07** HOW SPREADS HAVE MOVED – AUSTRALIA AND THE US




**Source:** Bloomberg, May 2020

**FIGURE 08** AOFM TREASURY NOTE ISSUANCE




**Source:** AOFM, May 2020

For agile cash investors, we see a pronounced opportunity to buy USD denominated short term paper, hedged back to AUD, at all-in yields of over one per cent. Furthermore, at times when liquidity is the primary focus, diversifying a portion of cash holdings into international markets may provide additional benefits, particularly when purchasing highly liquid government Treasury Bills.

## Treasury Note issuance by the Australian Office of Financial Management (AOFM) has seen a sharp increase, and will form an increasing part of cash portfolios

Given the enormous fiscal response to the COVID-19 crisis, Treasury Note issuance by the AOFM has increased dramatically, and will continue to do so.

This increased supply, combined with the collapse in short term bank funding requirements, is likely to see Commonwealth Treasury Notes continue to price above BBSW in the coming months.

The liquidity of the secondary market in Treasury Notes tends to be of interest to cash investors. Anecdotes suggest that during the most extreme phase of the liquidity event in the middle week of March, bids for Commonwealth government Treasury Notes by bank counterparties continued. This suggests that Treasury Notes remain relatively liquid investments. Further they tend to be a desirable source of diversification within cash portfolios. State governments are also likely to increase the issuance of Treasury Notes at levels above BBSW. Treasury Note liquidity is something that will continue to be monitored closely by the IFM Investors Treasury team[9].

## Australia's major banks are no longer AA-

On 7 April, Fitch downgraded the long-term ratings of Australia's four major banks to A+ from AA-, and their short-term ratings to F1 from F1+. The ratings agency cited concerns over asset quality and profitability given the economic shock resulting from the COVID-19 pandemic, and took the view that the TFF had the potential to encourage small business lending that may lead to higher levels of impaired loans. The major banks remain on negative outlook, with Fitch noting considerable downside risk in the event of a more prolonged, severe economic downturn, and higher levels of unemployment. The market reaction to this announcement has been virtually non-existent. The simultaneous downgrades occurred after the March peak in liquidity concerns, and credit spreads have continued to contract as April progressed.

We believe the Australian bank downgrades are important for investors to monitor for two reasons:

1. **Relative ratings** - There are now several issuers of Negotiable Certificates of Deposit (NCDs) in the Australian market that are rated higher than the four major banks. In some cases, these issuers offer spreads above BBSW. We believe conservatively managed cash portfolios that are limited to investing in major bank securities should consider allocating to some of these issuers with the aim of achieving:
   - Increased diversification;

[9] AOFM issuance data: https://www.aofm.gov.au/data-hub

- Improved rating profile;
- Improved returns.

IFM Investors notes that most of these issuers continued to offer NCD liquidity through the most difficult period in the middle of March.

2 **BBSW rate set process** - The ASX is examining the possible inclusion of non-major bank NCDs in the BBSW rate set process, but some issuers being rated higher than the major banks could present methodological challenges. Pricing is unlikely to be uniform as the composition of different issuers changes from one day to the next. These problems arguably existed already, given spreads over major banks' NCDs exist regardless of rating differences. However, having the major banks a notch lower than some other participants shines further light on any inconsistences. Given these complexities, we believe that BBSW is likely to remain restricted to the four major banks for the foreseeable future.

## Diversification can help with cash portfolio liquidity issues

During the COVID-19 liquidity crisis in March, some investors were surprised by how difficult it was to liquidate an entire cash portfolio within a few days. The FRN market justifiably received much of the attention, as the sudden widening of credit spreads provided a clearly visible indication of liquidity stress. However, relying on any one source of liquidity, be it at-call accounts, bank bills or even custodian accounts, has the potential to be dangerous. We believe that narrowing the criteria for what a cash portfolio can invest in might have the opposite effect of what is intended. For example, had all cash portfolios in Australia been restricted to major bank NCDs, it is plausible that the liquidity stress would simply have occurred in this market instead.

Nobel Prize laureate Harry Markowitz famously said that 'diversification is the only free lunch'. We think that applies to cash portfolio liquidity as much as it does to overall asset allocation. Diversification could take several forms, but of particular relevance in the coming month will be government and semi-government Treasury Notes, of which there will be plentiful supply. Global Treasury Bills hedged back to Australian dollars (AUD) can also offer an excellent source of liquidity and higher potential returns due to the cross currency basis. Finally, we believe FRNs still provide diversification and additional potential return at a time when rates are very low.

## Conclusion

In summary, we believe the current outlook for cash portfolios is very different to what it was before the COVID-19 pandemic.

The measures implemented by the RBA to assist liquidity have altered some fundamental money market relationships and a return to "normal' is unlikely in the near term. The RBA policy shift is also highly supportive of bank funding and we believe it will continue to force yields and spreads lower in cash and fixed income markets.

One of the major lessons for IFM Investors from the COVID-19 response is that cash portfolios can maximise liquidity through diversification. Whilst this may sound counterintuitive, holding a high proportion of securities in any one market (no matter how highly rated) is not a low risk strategy in illiquid market conditions.

Looking forward, we believe Trustees should consider including securities such as Treasury Notes in their portfolios, and possibly investing in offshore cash markets. There appears to be broader liquidity available in global cash and investors may also benefit from moves in the cross current basis (AUD/USD) that can create attractive relative value opportunities.

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