

# Investment markets research - "Thought piece"

6 July 2009

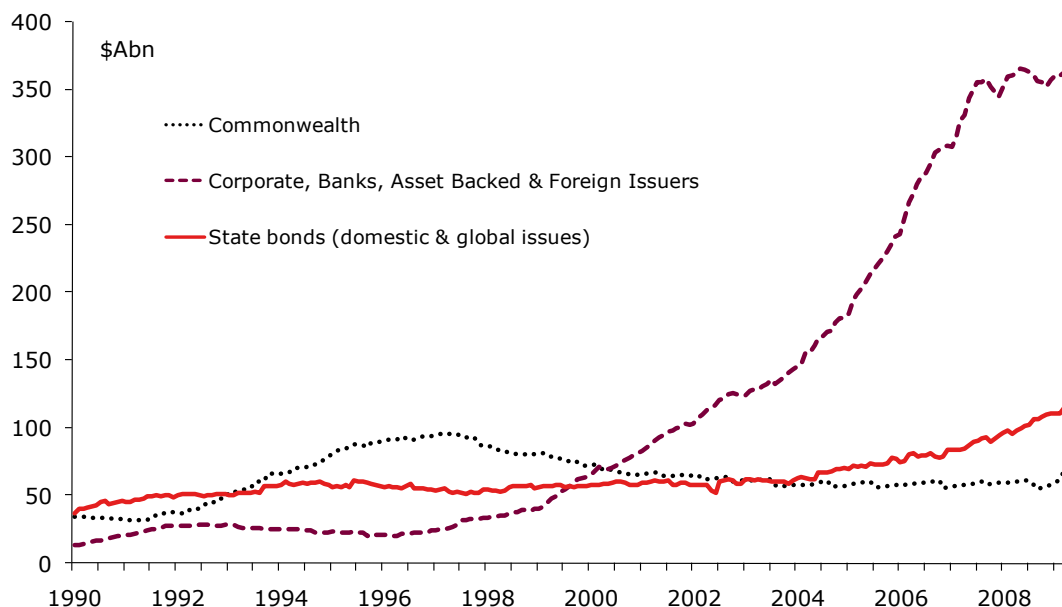
## "Take Me Back" - The changing structure of Australia's bond market

- After being dominated for many years by rising non-government bond issuance in an environment of government debt reduction, the structure of Australia's bond market will change dramatically again in the years ahead.
- Government budget deficits and funding for much-needed infrastructure will see both Commonwealth and State government (some with the Commonwealth guarantee) bond issues surge higher in the coming years. At the same time the pace of total net non-government bond issuance is expected to slow.
- As a result, after being over 50% of the total Australian bond market, non-government bond issues could shrink to around one-quarter of the market. State government bonds are likely to remain around 30%, but Commonwealth bonds will likely more than double from 20% of the market to over 40%. Increased government bond issuance is also likely to lead to a lengthening in duration of bond market indices.
- The coming surge in the supply of Commonwealth and State government debt has led to legitimate questions being asked about the potential demand for these bonds. We would be surprised, however, if investors, especially those offshore, including central banks, do not find Australian government bonds, in both Commonwealth and State form, an attractive addition to their Australian dollar portfolios.
- This dramatic change in the structure of Australia's bond market will, however, be an important factor for both investors and borrowers in the Australian economy and could bring with it implications for potential funding costs and returns in this sector of the market, as well as overall asset allocation.

### Introduction:

The year 2000 saw a significant change in the structure of Australia's bond market. In that year, for the first time, the supply of non-government or Corporate<sup>1</sup> bonds on issue exceeded that of Commonwealth government securities (CGS) and State-government bonds at around \$A60bn-\$A70bn for each sector. See Chart 1 for details.

**Chart 1: Australian dollar bonds on issue: Commonwealth, State and Corporate**



Source: RBA, Commonwealth Treasury, NSWTC & QTC

<sup>1</sup> In this paper, the term Corporate bonds refers to bonds issued in Australia in Australian dollars (AUD) by banks and other financial corporations, non-financial corporations, asset-backed securities and issues by non-residents, as defined by the RBA.

Since that time the supply of Corporate bonds in the market increased dramatically, peaking at near \$A365bn in mid-2008, while the supply of CGS declined to around \$A55bn-\$A60bn, with State-government bonds drifting up to just over \$A100bn. As at June 2008, Corporate bonds accounted for 52% of the UBS composite bond index, with State-government bonds at 28% and CGS at just 20%.

**As we progress through 2009 and looking to the years ahead, Australia's bond market is about to go through another significant period of restructure.**

One implication of the global financial crisis and global recession has been, of course, a significant loosening of fiscal policy that will lead to a substantial increase in the supply of government debt around the world. In Australia, this is manifesting itself in a sharp rise in the supply of both Commonwealth and State-government bonds.

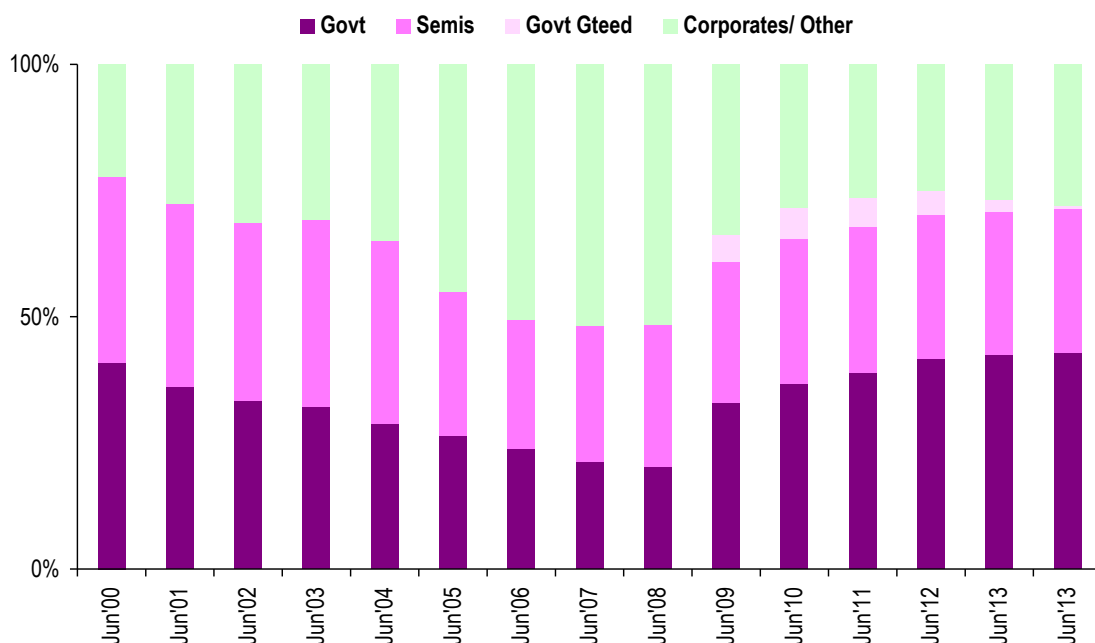
Using government data, the supply of CGS is now expected to rise to just over \$A300bn by June 2013, while State-government bonds on issue could be expected to jump to around \$A215bn in the same time-frame.

As a result of these changes, the UBS composite bond index is expected to go through a dramatic structural change in the years ahead. By June 2013, CGS is now expected to be as large as 42% of the index, with the State-government bond market at 28%, while Corporate bonds decline to approximately 27%. See chart 2 for details.

This expected change in the structure of Australia's bond market and the UBS composite bond index will likely have significant implications both for those with investments in Australia's bond markets and for fixed income fund managers.

It is also worth noting that the UBS composite bond index is likely to lengthen in duration, with the coming supply of Commonwealth and State government bonds likely to be for much longer maturities than Corporate bond issuance.

**Chart 2. The changing structure of the UBS composite bond index**



Source: UBS Investment Research

### The Commonwealth bond market: Some background

As the supply of CGS declined over the second half of the 1990s and into the current decade, thanks to consistent Budget surpluses and government debt repayment, much debate flowed in financial markets about the merits of retaining a 'liquid and efficient' Commonwealth bond market as an integral part of Australia's financial markets landscape and as an important benchmark for other potential bond market issuers.

By 2002, the Commonwealth government had sufficient financial resources to pay off the entire CGS market and, for a time, this appeared to be the government's preferred strategy.

However, after a long and detailed consultation process, the May 2003 Commonwealth Budget detailed that the (previous) government had decided to retain a liquid CGS market. This was an outcome welcomed by financial market participants.

The government concluded that “while financial markets may innovate in the absence of CGS, it is more likely that closing the CGS market would lead to slightly higher interest rates given the development of Australia’s financial markets and current lack of effective alternatives to CGS. This would result primarily from the higher costs associated with managing interest rate risk without a Treasury bond futures market.”

In addition, and perhaps more significantly given recent developments in global markets, the May 2003 Commonwealth Budget also stated “further, the Australian financial markets may become less diversified and more vulnerable during periods of instability.”

At the time, the necessary supply of benchmark CGS issues to maintain sufficient liquidity in the market was set at around \$A45bn-\$A50bn and, as shown in Chart 1, this level of supply was largely maintained from 2003 through to late 2008.

One of the other reasons put forward by financial market participants for retaining the CGS market was that there would be costs involved in rebuilding the CGS market, especially the futures contracts based on CGS, if/when the time came that the government needed to re-enter these markets to borrow funds.

We know that this time has well and truly come!

### The Commonwealth bond market: Supply outlook

The May 2009 Budget stated that there will be a significant increase in the issuance of CGS in 2009/10, to pay for the deficit for the coming year, with further substantial debt issuance expected out to 2012/13 and beyond.

After issuing only \$A5bn in 2007/08 and an estimated \$A35bn in 2008/09 (including \$A31.6bn in benchmark bonds), for 2009/10 the Australian Office of Financial Management (AOFM) will be required to issue a staggering \$A60bn in new debt. This will take total CGS on issue to just over \$A160bn, with an estimated \$A137bn of this accounted for by benchmark Treasury bond lines.

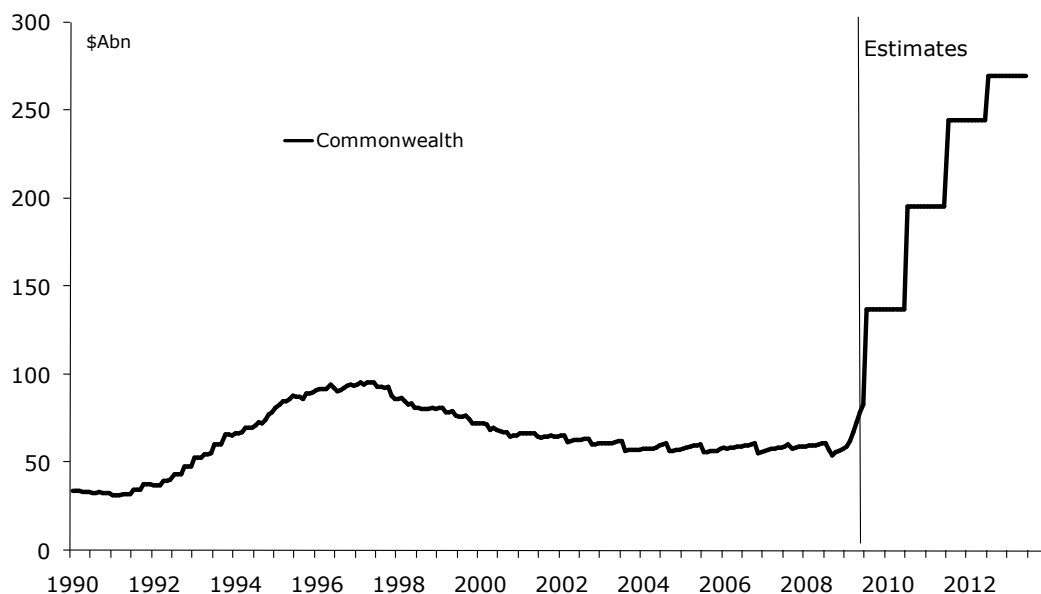
As shown in Table 1, taking into account the ongoing large budget deficits and bond maturity profile, total CGS on issue is expected to grow to just over \$A300bn by June 2013. Note: this will require an \$A100bn increase in the government’s current debt borrowing ceiling (which in February 2009 was raised from \$A75bn to \$A200bn).

**Table 1. Commonwealth government borrowing needs and debt issuance**

\$Abn	2008/09	2009/10	2010/11	2011/12	2012/13
Headline cash deficit	35.9	59.8	58.9	48.5	25.1
Maturities	5.1	6.0	16.1	7.1	7.7
Total funding requirement	51.0	65.8	75.0	55.6	32.8
Bond issues	31.6	60.0	75.0	55.6	32.8
Total net bonds issued	26.5	54.0	58.9	48.5	25.1
“Hot stock” on issue	83.0	137.0	195.9	244.4	269.9
Total securities on issue	107.4	161.4	220.3	268.8	300.8*

Source: Commonwealth Treasury & Colonial First State \* Commonwealth estimate, numbers may not add due to rounding.

The pace of the dramatic increase in the supply of CGS can also be seen in Chart 3.

**Chart 3. Commonwealth bonds on issue, actual and projected**

Source: Commonwealth 2008/09 Budget & Colonial First State Global Asset Management

The Budget papers stated that “the bulk of the issuance in 2009/10 will be into existing bond lines and will take account of the relative demand for lines of different maturities. At least one new Treasury bond line is planned to be issued in 2009/10. This is expected to be a Treasury bond maturing in 2022.”

Following the Budget the AOFM stated that for 2009/10 the bond selling program will include two tenders per week (for most weeks of the year), with total volumes of each tender to be in an \$A700m-\$A1bn range. It is worth noting that this would represent only a marginal increase from the recent issuance pattern, which has included two tenders per week of an average \$A700m in size.

The AOFM has also stated that “consideration will be given to issuing longer-dated Treasury Bonds and resuming issuance of Treasury Indexed Bonds. The issuance of such bonds would assist portfolio management by widening the range of available debt instruments, diversifying risk and potentially tapping additional sources of investor demand.”

“Issuance of longer-dated Treasury Bonds could also strengthen the overall functioning of Australian financial markets by providing pricing benchmarks for other long-dated instruments, such as public and private infrastructure bonds. Similarly, resumption of indexed bond issuance could assist in the debt financing of long-term infrastructure, since Treasury Indexed Bonds would serve as both a pricing benchmark and a risk management tool. Indexed financing can be attractive for those infrastructure projects whose revenues are linked to inflation. In addition, indexed instruments have advantages for investors with inflation-linked liabilities.”

In this regard the AOFM has begun a consultation period with financial markets participants, including Colonial First State Global Asset Management, with regard to the issuance of very long dated nominal and CPI-Linked Treasury bonds. Feedback from this consultation process is likely to be collated into H2 2009, with issuance into these markets likely to occur later in the year.

### The Commonwealth bond market: Demand outlook

**One of the key questions for the Commonwealth bond market is whether there will be demand to meet the coming supply.** In this regard, it is interesting to note the level of demand for CGS issues through 2008/09, especially as it became clear that the supply of CGS was going to increase dramatically.

As shown in Chart 4, while the bid/cover ratios<sup>2</sup> for CGS tenders have shown a large level of volatility, there has been very little deterioration since it became more obvious that the supply of CGS was going to ramp up.

From the start of the 2008/09 year up until October 2008 (ie. the first large fiscal policy easing) the bid/cover ratio was an average of 3.6 times. From October 2008 to the May 2009 Budget, as global and local economic conditions

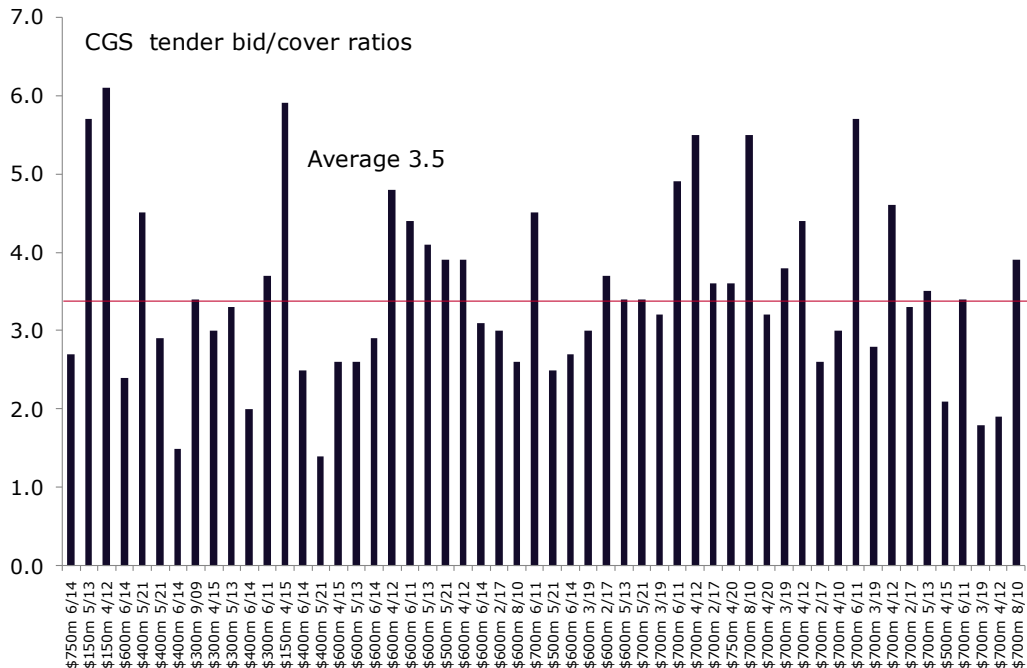
<sup>2</sup> Bid/cover ratio is the volume of bids received for each tender relative to the size of the tender.

deteriorated significantly and the government announced a more aggressive fiscal policy response, the bid/cover ratio fell only marginally, to an average 3.5 times.

From the May 2009 Budget to end June 2009, with a much clearer view on the coming supply of CGS, the bid/cover ratio has deteriorated a little, to 3.3 times. Tenders on 17 June and 19 June saw bid/covers of just 1.8 times and 1.9 times, respectively, but this improved back to 3.9 times on 24 June.

From this, therefore, we can conclude that, to date, there has been very little market indigestion in taking on the increased supply of CGS.

**Chart 4. CGS tenders bid/cover ratio in 2008/09**

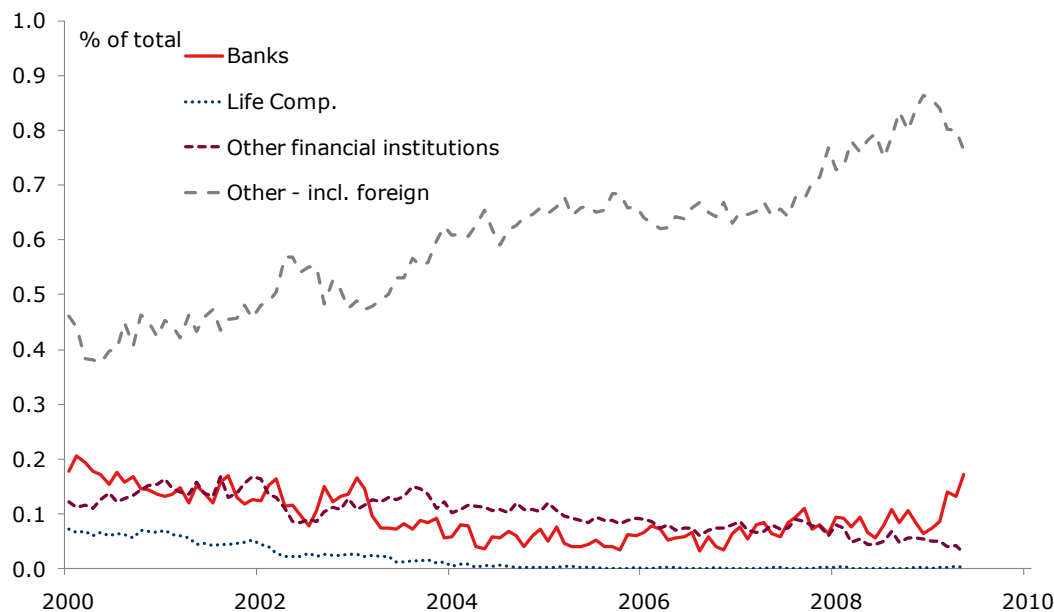


Source: Australian Office of Financial Management

Chart 5 shows the share of the CGS market held by different investors. As can be seen, Australian banks and other private financial institutions hold a relatively small share of the total CGS market, at approximately 14% and 4%, respectively.

The implication here is that, if Australian banks and other private financial institutions, as well as Australian life insurance companies, find Commonwealth government bonds more attractive in the years ahead, due, say, to rising yields, a better risk/return profile than alternative investments and/or greater liquidity, then there would be plenty of scope for these institutions to increase their ownership of CGS.

Chart 5. Share of CGS held by investors



Source: Reserve Bank of Australia

**There seems little doubt, however, that the largest share of CGS ownership will continue to be from foreign investors.** As shown in Chart 6, the level of foreign ownership of the CGS market has been steadily rising over a number of years and in May stood at 63.1% - although this was down from a peak just above 68% in late 2008, it compares to around 30% in the US, but up to 75% in New Zealand.

This foreign ownership is spread across the globe, including real money investors in Japan, the UK/EU and the US, as well as hedge funds in the UK and US. A significant portion of foreign ownership is also located among other central banks, especially those in Asia.

Many Asian central banks have made strategic allocations of their foreign exchange reserves into the AUD over recent years, generally as part of their diversification away from the USD. In addition, some countries in Asia have a natural desire to increase their AUD portion of foreign exchange reserves as their exposure to Australian commodity exports also rise.

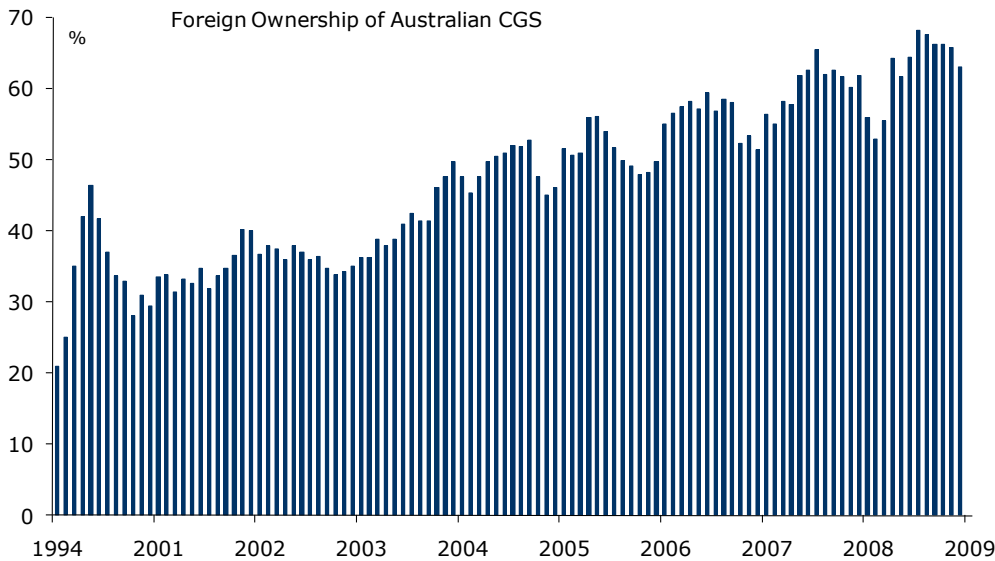
For these countries it would seem to make sense to expect a continued allocation into AUD investments, including into a growing pool of CGS, based on the higher yields available, Australia's relatively solid AAA/Aaa credit rating (see below for details), general more upbeat expectations for the Australian economy, Australia's more-solid financial institutions and the growing pool of liquidity that will become available in CGS.

Recent legislation passed to provide the Commonwealth guarantee on State debt also included the establishment of a register of beneficial ownership of Commonwealth and State bonds. There has been some concern expressed that this level of information could deter foreign bond investors, but we doubt that this would be the case given that countries like the US, Canada and New Zealand already collect similar data.

In addition, there are some expectations that interest withholding tax (IWT), currently imposed at a 10% rate on coupon payments on Commonwealth bonds for foreign investors, (note, IWT was abolished on State government bonds in 2008 and on Corporate bonds in 2001) could be abolished in the near-term. Any abolition of IWT is likely to act to attract increased foreign investor interest in the CGS market, as it would increase the return on this investment (ie. lower the tax). We would see the abolition of IWT, therefore, as a positive step.

**It could be expected, therefore, that a large part of the coming increased supply of CGS could be taken up by foreign investors, especially including Asian central banks.**

**Chart 6. Foreign ownership of the CGS market**



Source: Reserve Bank of Australia and Colonial First State Global Asset Management

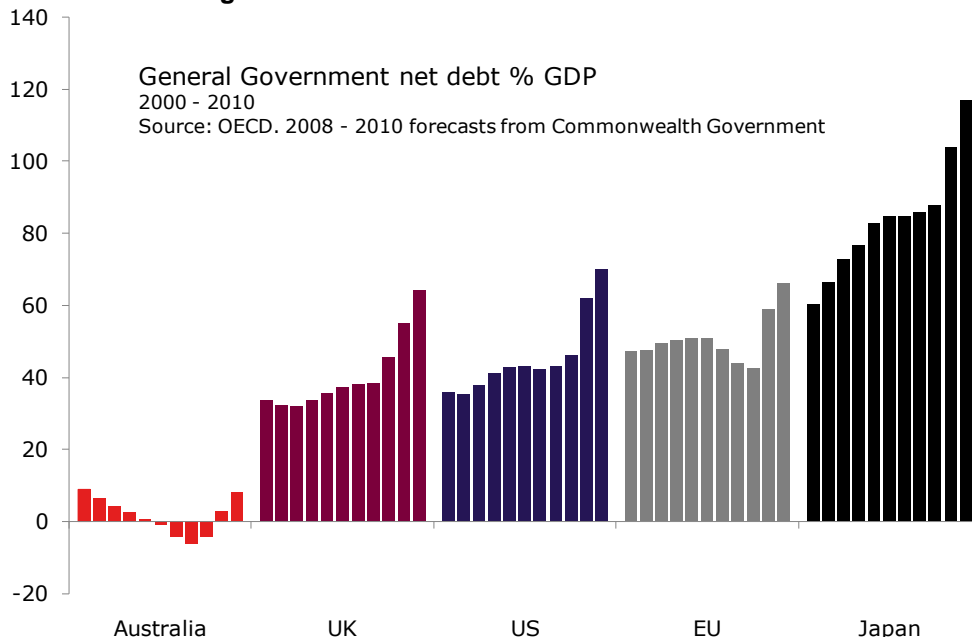
**Australia’s net debt levels and credit rating**

One of the potential concerns for investors in the CGS market is the impact on Australia’s growing government debt levels on the AAA/Aaa credit rating. As shown in Chart 7, from an estimated net asset position of \$A44.8bn, 4.0% of GDP, as at June 2008, the Commonwealth government is now expected to have net assets of \$A4.7bn, or 0.4% of GDP, at June 2009.

The government will then quickly move back into a net debt position, estimated at \$A53.7bn, 4.6% of GDP, at June 2010 and \$A188.2bn, 13.6% of GDP, at June 2013. The Budget papers then indicate that net debt to GDP is expected to peak at 13.8% at June 2014, before declining back to 3.7% of GDP by June 2020.

While this is a significant deterioration in Australia’s net debt position, it still places Australia in a vastly superior position to most other OECD nations. Indeed, Budget papers note that “between now and the end of 2014, average net debt levels in major advanced economies are projected to increase to over 80% of GDP.” While the credit rating agencies have expressed some confidence that the 2009/10 Budget and projections for the outyears are consistent with an AAA credit rating, complacency should be avoided.

**Chart 7. General government net debt levels % GDP**



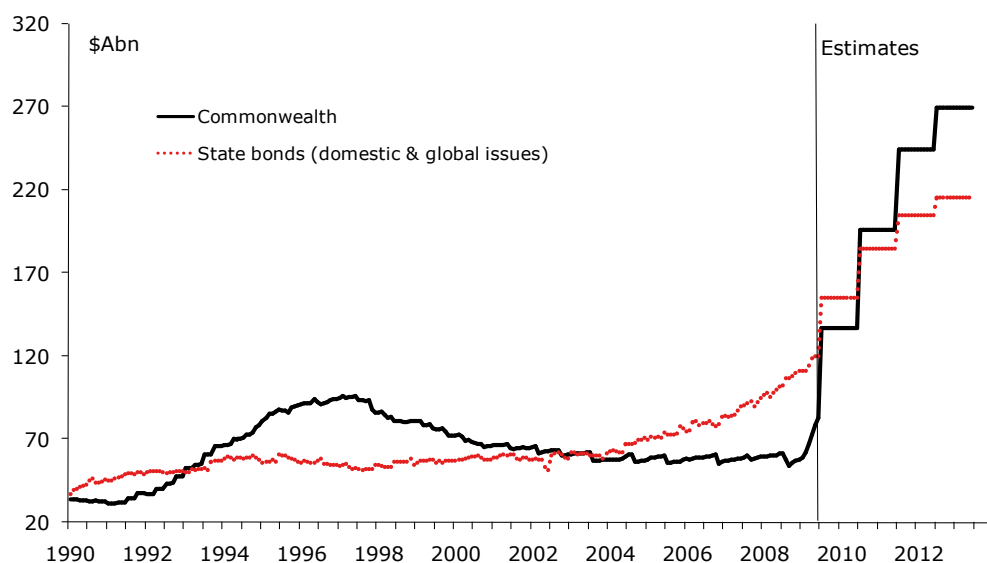
Source: Commonwealth Budget 2009/10

## The State government bond market

The supply of State-government bonds is also expected to increase sharply in 2009/10 and the years ahead. This increase in debt will come on the back of the sharp move into budget deficit for most of the States, as revenues fall rapidly, and to fund a significant increase in infrastructure spending.

From near \$A120bn as at May 2009, the total volume of State-government bonds on issue (combined domestic and global/exchangeable issues) is expected to grow to around \$A155bn as at 30 June 2010 and then to \$A215bn as at June 2013. As shown in Chart 8, this will keep the State-government bond market larger than the CGS market until the 2010/11 financial year, but with the CGS market then becoming larger for the years ahead.

**Chart 8: Total State-government and Commonwealth bonds on issue – Actual and forecast**



Source: Commonwealth Treasury, State Treasury's & Colonial First State Global Asset Management

For each of the Australian States, their specific borrowing needs are detailed below, please also see Table 2:

**NSW:** The NSW Treasury Corporation (NSWTC) has stated that their 2009/10 borrowing program will total \$A10.4bn. This will comprise \$A5.5bn in the refinancing of maturities and \$A9.9bn in new borrowings. This total of \$A15.4bn will be offset by \$A5bn in borrowings "pre-funded" in the 2008/09 year, where total borrowings stood at \$A10.3bn, relative to a borrowing program of just \$A5.3bn.

For 2010/11 net debt for NSW is expected to increase by a further \$A6.5bn, then by around \$A5bn in 2011/12 and a further \$A3.5bn in 2012/13. Total NSWTC bonds on issue are expected, therefore, to increase from around \$A36bn at present (domestic and exchangeables combined), to approx. \$A46.5bn by June 2010 and then approx. \$A61.5bn by June 2013. This will keep NSWTC as the second largest of the State-government bond issuers.

Despite recently having its AAA/Aaa credit rating affirmed (with Standard & Poor's raising the credit rating outlook from 'negative' to 'stable'<sup>3</sup>) the NSW government has announced (23 June 2009) that they will "take up the Commonwealth's guarantee on state borrowings." The NSW Treasurer stated that "taking up this guarantee ensures the cost of borrowing for NSW will be as low as possible. NSW will take up the guarantee for both new and existing debt which matures beyond 2012." NSWTC has stated that this will include both the Domestic and Exchangeable bonds with the following maturities: May 2013, August 2014, March 2017, April 2019 and May 2023.

**Victoria:** The Treasury Corporation of Victoria (TCV) has stated that their 2009/10 borrowing program will total \$A5.6bn. Further increases in Victoria's net debt of \$A4.5bn-\$A6.5bn are then expected for 2010/11 and 2012/12,

<sup>3</sup> See Standard & Poor's, 16 June 2009

trailing away to just over \$A1bn in 2012/13. This is expected to see the amount of TCV stock on issue rise from around \$A13.5bn at present to \$A19.1bn by June 2010 and then to just over \$A31bn by June 2013.

Victoria has announced (23 June 2009) that they “will not take up the Commonwealth government’s offer of a bond guarantee at this stage, thanks to the strength of Victoria’s finances.” The Treasurer of Victoria stated that “Victoria’s unique financial strength, with a surplus now and into the future, a strong AAA credit rating and a relatively small requirement for bonds supports the State’s capacity to finance its requirements in its own right, without paying a guarantee premium.”

**Queensland:** The Queensland Treasury Corporation (QTC) has announced that their borrowing program for 2009/10 will total a very large \$A22.5bn, with \$A11.5bn of this in new borrowings. For future years, QTC’s borrowing program is expected to remain very large, with Budget papers showing an increase in net debt of \$A11.3bn in 2010/11 and \$A8.2bn in 2011/12, before trailing down to \$A4.5bn in 2012/13. This is expected to see the total volume of QTC bonds on issue rise from around \$A55bn currently to \$A66.4bn at June 2010 and then \$A90.4bn at June 2013. QTC will, therefore, remain the largest of the State-government bond issuers.

Largely because of its substantial borrowing program (which is being used to fund a significant increase in infrastructure spending) and lower credit rating, QTC has announced that they will be taking advantage of the Commonwealth’s guarantee of State-government bonds. On 16 June 2009 QTC detailed that six current bond lines (the June 2011, April 2012, August 213, October 2015, September 2017 and June 2021), totalling just over \$A40bn, will be guaranteed by the Commonwealth. The Treasurer of Queensland also stated that QTC “intended to apply the guarantee to future bond line issues, but reserved the right to issue non-guaranteed bond lines.”

**WA:** The Western Australia Treasury Corporation (WATC) has stated that their 2009/10 new money borrowing program will total \$A5.1bn. For the 2010/11, 2011/12 and 2012/13 financial years, the Budget papers show net debt increases of \$A3bn, \$A2bn and \$A1.5bn, respectively. This would imply WATC debt on issue rising from just over \$A11bn at present, to \$A16.3bn at June 2010 and then to \$A22.8bn at June 2013. The WA Treasurer has stated that WA will not use the Commonwealth’s guarantee, noting that “in doing this, we took into account the State’s borrowing requirements and the cost of the Commonwealth’s guarantee fee.” This decision mirrors that, therefore, of Victoria.

**SA:** The Budget papers show that SA’s expected increase in net debt in 2009/10 and outyears remains very modest compared to the other States. For the coming year SA net debt is expected to increase by \$A2.2bn and then by \$A1.1bn in 2010/11. For 2011/12 and 2012/23, no substantial increase in debt is expected. This implies that South Australian government Financing Authority (SAFA) bonds on issue should be expected to increase to around \$A6.6bn at June 2010, from \$A4.4bn currently, and then to \$A8bn by June 2013. As is the case with WA, SA is yet to publically state their position on the use of the Commonwealth’s guarantee.

**Tasmania:** The Tasmanian Budget papers imply very modest increases in net debt for Tasmania in 2009/10 and the years ahead, meaning that total TasCorp (Tasmanian Public Financing Corporation) bonds on issue will increase from around \$A2.8bn currently to \$A3.5bn at June 2010 and just under \$A4bn at June 2013 – keeping TasCorp as the smallest of the State-government bond issuers. On 1 July 2009 TasCorp stated that their borrowing program for 2009/10 was just \$A780m (including \$A485m for new investment and \$A295m refinancing). TasCorp also stated that they “expect to launch new lines of Commonwealth guaranteed hotstock and to continue to issue non-guaranteed bonds under its existing lines of hotstock. We do not intend to seek a guarantee for existing hotstock.”

**Table 2: Summary of State details**

State	Borrowing program 2009/10	To use Commonwealth guarantee	Credit rating (S&P/Moody’s)
NSW	\$A10.4bn	Yes	AAA/Aaa
Victoria	\$A5.6bn	No	AAA/Aaa
Queensland	\$A22.5bn	Yes	AA+/Aaa
WA	\$A5.1bn	No	AAA/Aaa
SA	\$A2.2bn	?	AAA/Aaa
Tasmania	\$A0.8bn	Yes new/No existing	AA+/Aaa

Source: State Treasury Corps, S&P and Moody’s

## Commonwealth guarantee of the States

The almost 25-year history of the Australian State government bond market changed significantly in late March 2009, with the Commonwealth government offering the States a guarantee for their debt (for a fee). This was a good indication of how dysfunctional the State government bond market had become and how difficult it may have been for the (larger) States to borrow money in financial markets to fund nationally significant infrastructure projects.

In the press release announcing the Commonwealth guarantee of State debt, Treasurer Swan stated the decision was taken to “support jobs and protect vital infrastructure plans from the global recession by providing a time-limited, voluntary guarantee over State government borrowing.”

On 12 May 2009, ie. in the Budget, the Commonwealth announced further details on the guarantee, with legislation passed on 17 June 2009 by the Parliament (now awaiting Royal Assent and fine-tuning of the details of the scheme).

The key features of the Commonwealth guarantee of State debt are as follows:

- The guarantee is voluntary and is available to both existing bonds and new issuance, but will not extend to bonds issued in foreign currency;
- The guarantee is limited to bonds with a maturity of up to 15 years, but will also include inflation linked securities.
- States will also have the ability to “buy back guaranteed securities and either warehouse them without extinguishing the guarantee or extinguish both the securities and the guarantee over them.”
- Once a State issues a guaranteed bond they will then have 28 days to decide if they wish to have the Commonwealth guarantee on their existing lines of bonds and indeed which bonds in their maturity profile they wish to have guaranteed;
- The fee the Commonwealth will charge the States is as per the table below. The Commonwealth has stated that the fee has been set at a level that will “provide a balance between facilitating access to the market whilst also providing a disincentive to use the guarantee once market conditions have normalised.”
- The Commonwealth has also stated that the “guarantee fee arrangement will be reviewed on an ongoing basis and revised if necessary.”
- In addition, the Commonwealth has stated that “the Loan Council will provide an additional level of transparency and rigour to the operation of the guarantee” and that “State borrowing requirements will continue to be considered by the Loan Council.”
- Strengthening this oversight, the Commonwealth also stated that “in particular, scrutiny via the Loan Council will ensure that the States have to account for their infrastructure spending.”

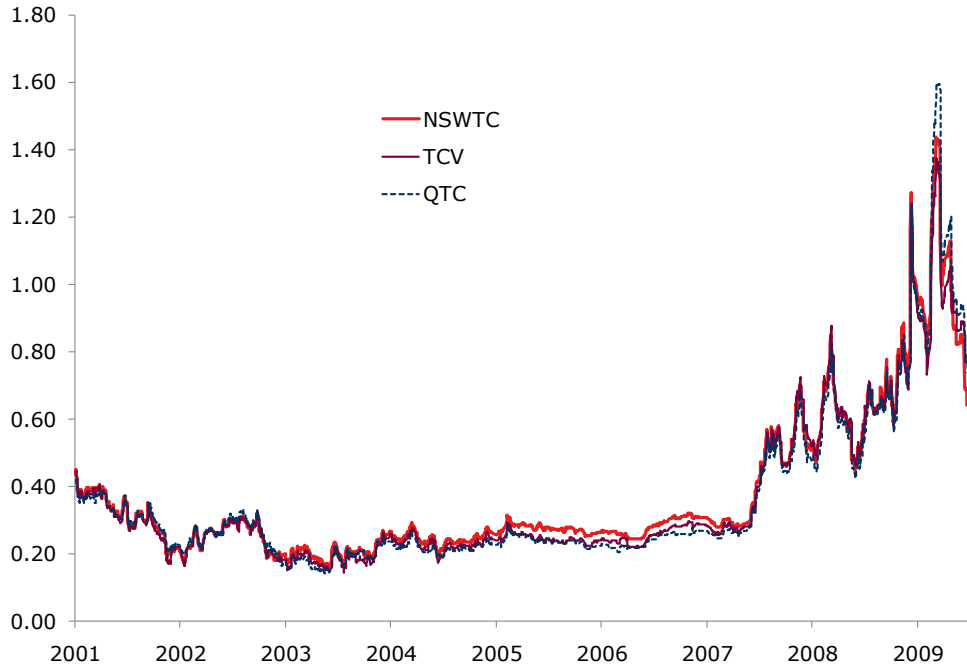
Credit rating	Fee for existing stock	Fee for new stock
AAA (NSW, Vic, WA, SA)	15bp	30bp
AA+ (Qld, Tas)	20bp	35bp

Source Commonwealth Treasury

As shown in Chart 9, the State-government bond market has responded positively to the announcements from QTC and NSWTC that they will take up the option to use the Commonwealth’s guarantee. This has manifested itself in a strong rally in QTC and NSWTC (and to some extent TCV) spreads to CGS.

This spread narrowing has also likely been supported by the general improvement in financial market conditions in the past few weeks and news that both NSWTC and QTC have been able to issue bonds into the market (with the assumption they will become guaranteed) by a book-build process.

**Chart 9: NSWTC, QTC and TCV 10yr spreads to CGS**



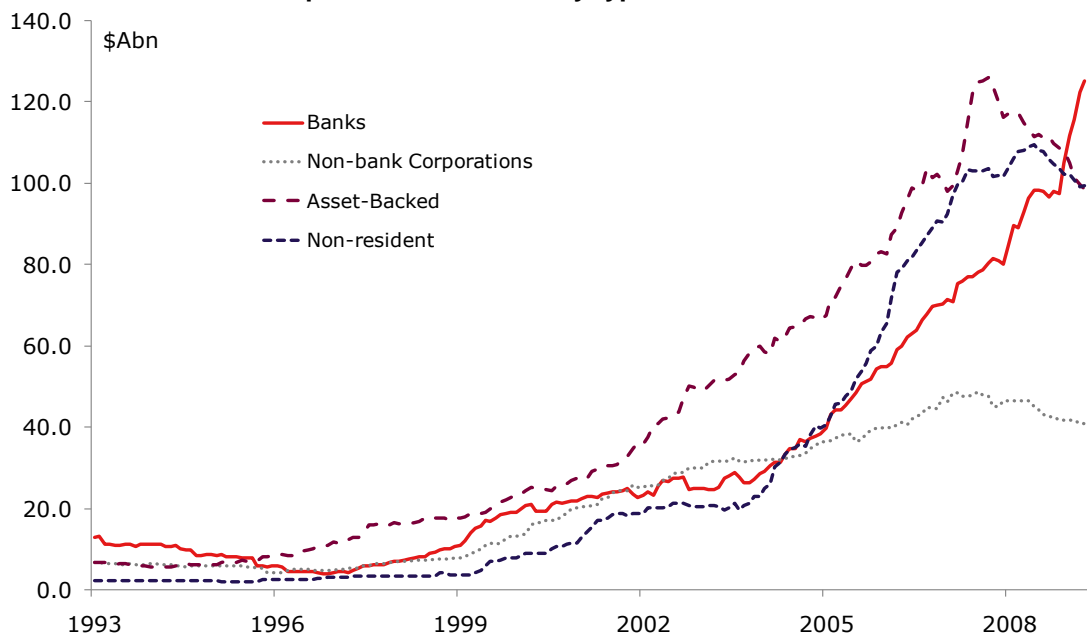
Source: Citi

**The Corporate bond market**

As at April 2009 the Australia Corporate bond market had \$A364.6bn bonds on issue and, as shown in Chart 1, was significantly larger than both the CGS and State-government bond markets. As shown in Chart 10, the Australian corporate bond market is dominated by Bank bond issues (34.4%) – which have surged through the worst stages of the global financial crisis, see Chart 11 for further details.

After Bank issues, the next largest issuer is from non-Australian entities (at 27.3%), closely followed by asset-backed securities (at 27.1%). True Australian non-financial corporation bond issues only account for a relatively small 11.2% of the market.

**Chart 10: Australian Corporate bond issues by type**



Source: RBA

In contrast to the CGS and State-government bond markets, which are defined by a small number of issuers and a small number of benchmark bond lines, the Corporate bond market (based on the UBS Australian Credit index) has over 100 different issuing entities, with a total of approximately 210 individual securities on issue.

Of the over 100 different issuers, only around 57% are Australian domiciled companies, with the other 43% non-Australian domiciled. In terms of value of issuance, the split is almost even, with only 51% of AUD issuance composed of Australian domiciled names.

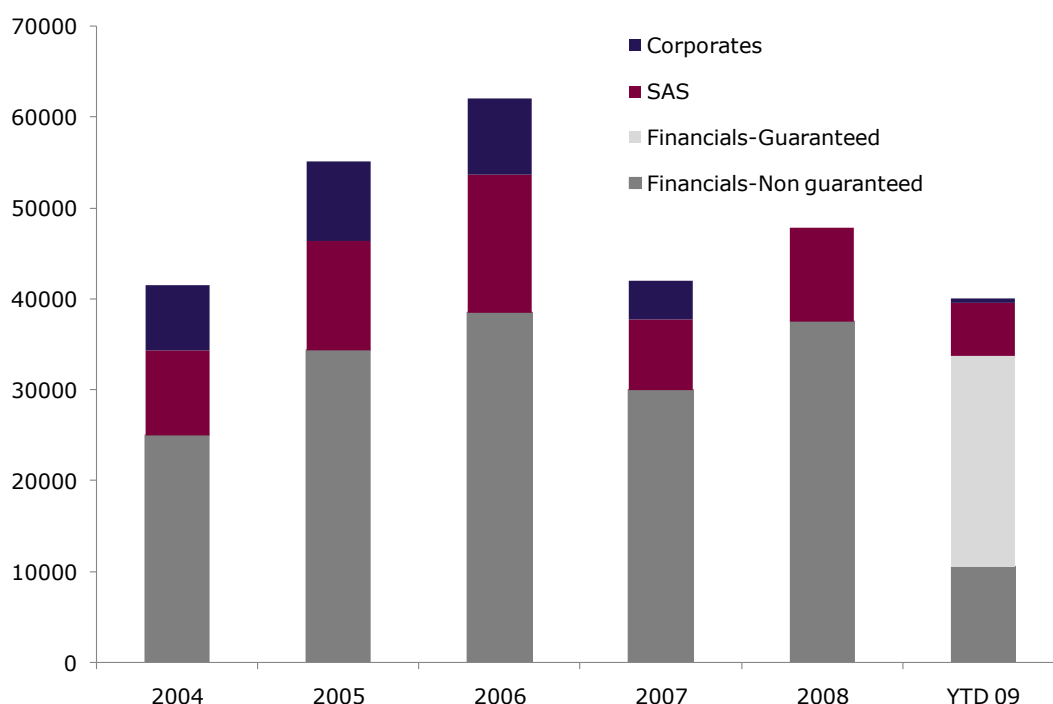
This data indicates that the so-called “Australian Corporate bond market” is not especially indicative of Australian credit market performance and, in addition, lacks depth and liquidity. This is also reflected by the growing trend for “price making” in the Australian Corporate bond market to be undertaken offshore and a subsequent reduction in the level of direct research being undertaken on Australian corporate bond issuers.

According to data from Citigroup, and as shown in Chart 11, total issuance into the Australian Corporate bond market so far in 2009 has been close to \$A40bn – a record for this time of the year and compared with total issuance of approx. \$A48bn for all of 2008. This record issuance for 2009 has been dominated, however, by government-guaranteed bank issuance, at \$A23.3bn, or 58% of all bonds issued.

Of the remaining issuance, approx. 26% has been for non-government guaranteed bank issues, with a further 14% from offshore supra-national and sovereign issuer (SAS), with only 1.5% from Australian non-financial corporations.

This again highlights the view that the Australian Corporate bond market represents only a very small proportion of the Australian corporate community, with the market, especially over 2008 and 2009, dominated by Australian banks – now issuing both Commonwealth government guaranteed and non-guaranteed debt.

**Chart 11: Australian Corporate bond issues – Annual issuance by type**



Source: Citi

## Total bond market supply

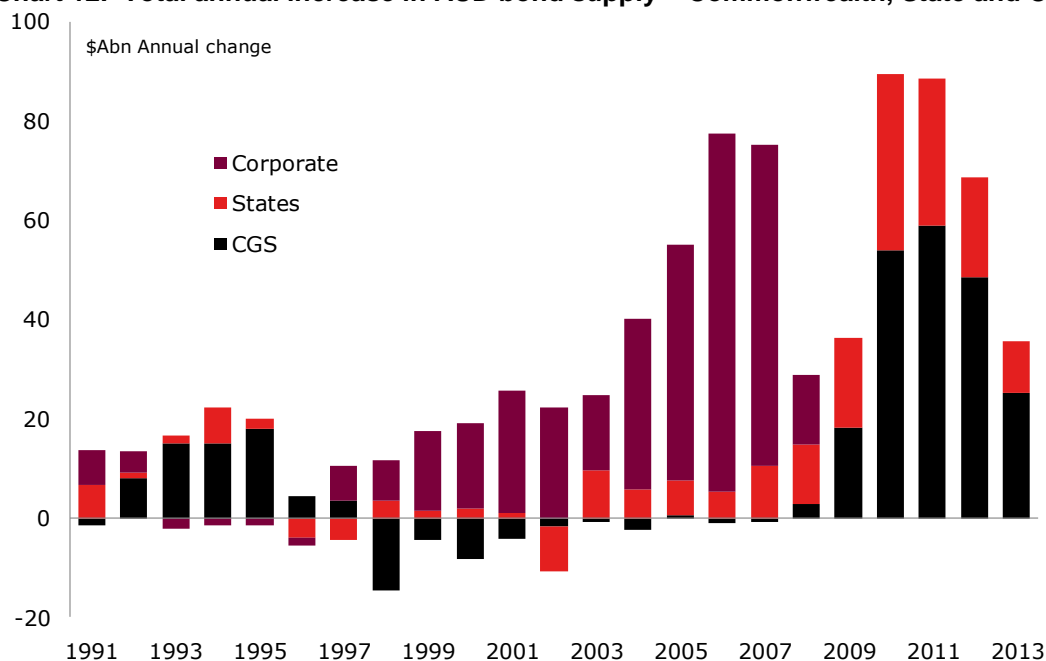
As shown in Chart 12, the coming few years, especially 2009/10 and 2010/11 will see a dramatic increase in the supply of AUD denominated bonds into the local market, at approximately \$A90bn and \$A88bn respectively. This supply will be dominated by both the Commonwealth and State governments, with net new supply from the Corporate sector likely to be minimal.

It should be noted, however, that the AUD bond market has seen other years where the total new net supply of bonds was almost as high, such as \$A55bn in 2005/06 and approximately \$A75bn in both 2005/06 and 2006/07. Of course, in those years the dramatic increase in the net new supply of bonds was dominated by the Corporate bond sector and not the government.

But the fact remains that investors in AUD-denominated bonds have experienced previous years of dramatic increase in bonds on issue and this large increase in supply was met with sufficient demand. While the mix of supply will change dramatically in the years ahead, the total increase in debt demanded by the economy is not unprecedented.

In this environment, however, we have assumed that the net new demand for debt from the Corporate sector will be very low in the years out to 2012/13 and so there will be limited “crowding out” of the private sector. While this is likely to be the case over the next 12-18 months, with the economy growing well below trend, there is the risk that continued government bond supply into the 2010/11 year and beyond, when the economy is forecast to be back growing above trend, could “crowd out” any potential return of demand for debt from the Corporate sector.

**Chart 12. Total annual increase in AUD bond supply – Commonwealth, State and Corporate**



Source: Commonwealth Treasury, State Treasuries, RBA and Colonial First State Global Asset Management

## Summary

In conclusion we would make the following key points:

- The Australian bond market is set to undergo a significant restructure in 2009/10 and the years ahead, with a surge in the supply of Commonwealth government and State government bonds (some with a Commonwealth guarantee), while the Corporate bond market will likely shrink sharply as a share of the total market.
- The main source of increased supply in the Australian bond market will be the Commonwealth, with total securities on issue (CGS) to surge from around \$A100bn at present to over \$A300bn in 2012/13.
- The primary source of this supply will likely be in nominal Treasury bonds, but with also increased issuance of shorter-dated Treasury Notes, very long-dated Treasury bonds and the expected return on Inflation-linked bonds.

- So far the increase in supply of CGS has met with relatively solid demand. While periods of market indigestion should be expected, the increase in supply of CGS is likely to meet with relatively solid demand in the years ahead, especially from foreign investors who continue to dominate the market.
- The State-government bond market will also see a significant increase in supply, helping to fund both budget deficits and significant infrastructure investment.
- The largest increase in supply will come from NSW and, especially, Queensland. Both these States have, therefore, announced that they will use the Commonwealth guarantee for existing and new debt. This should help ensure solid demand for these bonds.
- Victoria has, in contrast, announced that they will not use the Commonwealth guarantee, instead relying on their own strong balance sheet and credit rating, while Tasmania will use the Commonwealth guarantee for new debt, but not existing.
- The Australian Corporate bond market is now dominated by the banks, who have been actively issuing both Commonwealth guaranteed and non-guaranteed debt.
- While there also has been some supra-national and semi-sovereign (SAS) bond issuance, which is a good potential source of AAA rated yield, the volume of Australian non-financial corporation debt issuance has shrunk dramatically, leaving the Australian Corporate bond market with very little relationship to the Australian corporate sector.
- In total, while the coming supply of debt into the Australian bond market is large, at almost \$A90bn in both 2009/10 and 2010/11, this is not too much more than the annual increase of around \$A75bn seen in 2005/06 and 2006/07.
- The difference is, of course, that the earlier episodes of significant increase in bond supply were dominated by the Corporate bond market (in an era of government debt reduction), while this time around it is the government's (both Commonwealth and State) that will provide the supply.
- While this could have implications for the interest rate/yield the market demands for the different sectors of the economy, especially on a 1-2 year view, it is unlikely to prove too challenging for overall demand of AUD-denominated bonds.

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