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YIELD HUNGRY INVESTORS

HEAD TO OZ

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Asiamoney and National Australia Bank's latest poll on Asian and European investors' appetite for Australian debt tells a story of consistency and stability as the region presents a safe option amid turbulence - while also offering sustainable opportunities.

A favourable macroeconomic backdrop with a robust growth trajectory has made Australia's economy stand out from many of its regional peers. The country's bond market too is reaping the rewards of this stability as debt investors remain resolutely focused on the market.

That's according to a recent poll conducted by National Australia Bank and Asiamoney, which analysed the investment behaviour of bond investors in Asia and Europe. Out of the 75 investors who responded to the question on their exposure to the Australian bond market, about 25.3% had boosted their overall exposure in the past 12 months, versus 12% that had reduced their exposure. About 62.7% had kept their Australian bond portfolio unchanged.

The overall outlook too is positive. While 64% of the respondents plan to keep their exposure to the country's bond market stable over the next year, some 28% intend to beef up their portfolios, while only a small 8% will cut it down.

It's easy to see why investors are optimistic about Australia. The country has enjoyed a comparatively robust economic performance over the past few years, has seen a pick-up in public investment growth amid a boost in infrastructure spending, while employment growth has gone from strength to strength. Adding to the appeal is also the fact that banks in the country have improved their resilience to negative housing and other shocks, and bettered their funding profiles over the past year.

This strength and stability, at a time when geopolitical volatility globally is on the rise, makes Australia a natural destination for bond investors. But the main drivers for investors looking to increase their exposure to the Australian market over the next 12 months have changed.

About 40% of the respondents to this question said diversification benefits are the biggest driver for their plans to boost their Australian

bond exposure. In second place - with equal 30% of the votes - are yields on an absolute basis as well as company specific factors. Access to green or sustainable bonds followed close behind (25%), as did sector specific issues (20%).

The results are in contrast to a similar poll in 2017, where a whopping 56.3% of the respondents pointed to geographic diversification as a motivating factor for adding Australian debt to their portfolio. This was followed by attractive rates (54.9%) and solid credit ratings (35.3%).

"The increased appetite for Australian bond exposure is not surprising," says Jacqueline Fox, general manager, capital markets and advisory, at National Australia Bank. "Australia is a relatively stable jurisdiction, with a strong banking sector capital base, prudent regulators, a growing population which is driving infrastructure and property investment and well regarded corporate entities.

"In addition, this year we also saw increased appetite for green and sustainable bond investments which Australian issuers themselves have been conscious of and have responded to with increased issuance volumes. This is a similar story for New Zealand. This could be a reason for the slight decrease in year-on-year geography diversification identified in the survey."

While investors want more yield, they have kept their preference for different kinds of Australian credits relatively steady. Some 30.16% of the 63 respondents to this question said they were invested in investment grade corporate bonds - the highest proportion after other types of notes - versus 39.4% last year. But while investment into financial institutions came second last year with 35.2% of the respondents invested in that segment, this time around, a smaller 26.99% had put their money into financial institutions.

Instead, government bonds proved a tad more popular with 28.57% of the respondents buying Australian government notes.

GREEN MOMENTUM

When markets get choppy, there is typically a flight to safety, with Japanese and US government bonds often the winners. Australia is no different. Australian government bonds have seen gains in recent weeks as investors moved into safe heaven purchases following rising trade tensions between the US and China.

The rising appeal of Australian government bonds is also in line with the fact that various government-related entities have made a big push towards the sale of environmental, social and governance (ESG) related bonds. Both the Queensland and Victoria state governments have sold green bonds in the past, with more Australian state treasuries expected to go down the same route.

Obviously, pricing is key for issuers and investors, but this is even more keenly watched in the green and sustainable financing market, where, globally, issuers are yet to see clear pricing benefits in selling green bonds versus conventional notes. Investors too are only warming up to the asset class in Australia, despite borrowers from the country becoming one of the early movers in the green market.

Of the 61 investors that tackled the ESG-related question, 75.41% said they don't invest in any ESG-related bonds, citing lack of attractive pricing, absence of good quality credits and capacity restraint in following through. But green issuers may have reasons to be cheerful. Some 25.8% of investors intend to increase their exposure to ESG-related products in the next year - some by less than 10%, and others by between 10% and 25%.

As a result, some reallocation within portfolios appears to be on the cards. Of the investors planning to increase their ESG exposure in the next 12 months, 56.25% will maintain their overall exposure to the Australian fixed income market while the rest (43.75%) will boost their overall exposure - a clear sign the buy-side is looking to shift more money into ESG-related products.

Of those already invested in ESG, 40% had not changed their overall exposure to Australia in the past 12 months while 53.33% had boosted their overall exposure.

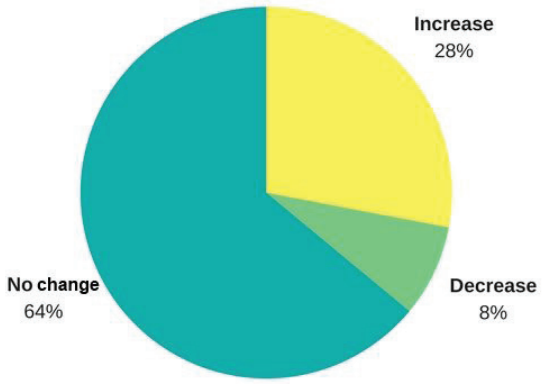
But in general, what do investors look for when deciding whether or not to invest in Australia's bond market? And what currencies do they favour? These have changed over the past year.

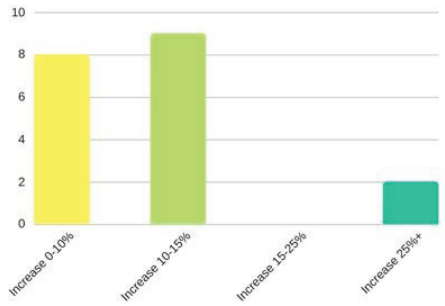
RETURNS, TENORS IN THE SPOTLIGHT

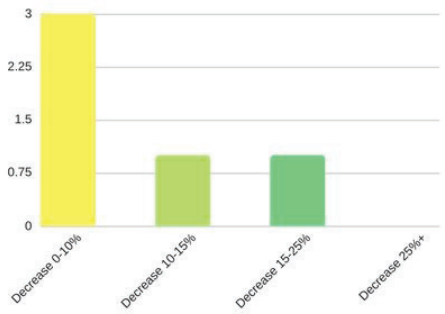
Yields dominated investors' minds with an impressive 46.15% of the 65 investors polled voting for this category as the main consideration when buying bonds issued by the country's borrowers. This was followed by macro-economic outlook and ratings - both receiving approximately 38.5% of the votes each - with appealing yields on a cross-currency swap basis stealing the fourth spot at 26.15%.

Last year, however, 72.3% of the investors polled thought credit rating was an essential factor in their investment decision, while yield

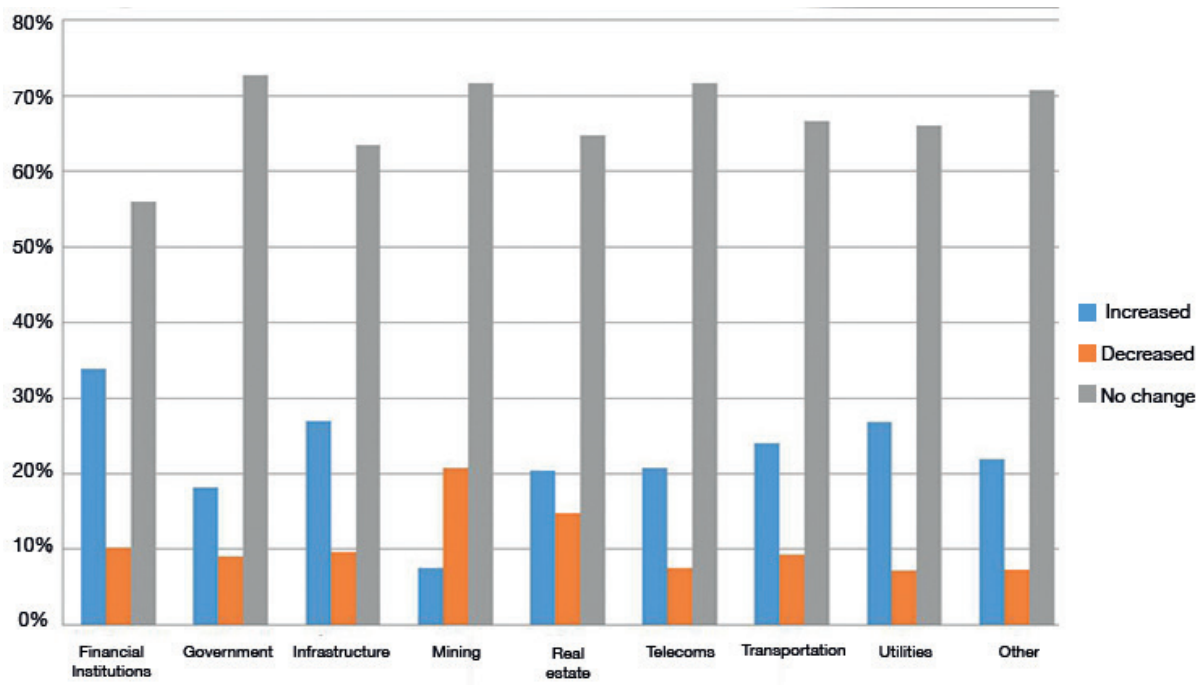
HOW ARE YOU PLANNING TO CHANGE YOUR EXPOSURE TO THE MARKET OVER THE NEXT 12 MONTHS?







HOW HAS YOUR EXPOSURE TO DIFFERENT SECTORS IN THE AUSTRALIAN MARKET CHANGED?



was considered essential by 51.5%. The industry or the sector of the issuer and tenors were considered reasonably important, with 60.9% of the respondents picking the former, and 52.3% the latter.

Investors' currency preference has also seen a sea change. About 77.46% have exposure to US dollar-denominated Australian bonds, a rise from the 70.4% last year. But perhaps more importantly, their appetite for euro-denominated Australian notes has seen a big jump.

Around 45% of those polled this year have euro exposure, whereas last year, just 19.7% were interested in euro notes from Australia. Of the investors polled in 2018, 54 were based in Asia, 17 in Europe, four in Australia and one in the US. Of these, 71 accounts responded to the question on currency exposures.

Their demand for euro notes is also expected to remain strong. Of the respondents that have a euro portfolio of Australian notes, 15.28% intend to bump up their exposure in the next 12 months, while only a small 2.78% will reduce it. The remaining will keep their coverage unchanged.

Issuers too are taking advantage of investors' rising interest in euros. As of April 23 this year, some 26 euro-denominated transactions from Australia have been sold, worth close to $12bn, according to Dealogic. In contrast, only 12 deals worth around $4bn-equivalent were printed at the same time last year.

Financial institutions dominated the space, with the likes of ANZ, Commonwealth Bank of Australia, Macquarie Group, NAB and Westpac Banking Corp among the euro bond sellers.

But financials are not the only ones looking to jump on the euro bandwagon. Names such as Ausgrid Finance, an infrastructure investment company, have also gone the euro route, printing a €650m 1.25% 7.25 year note in mid-April.

"We have seen increased euro denominated issuance this calendar year which has largely been driven by favourable comparable all in pricing and issuer's own diversification objectives," says Fox. "The financial sector has accessed this market for both of these reasons. Likewise we have seen euro issuance from the corporate sector. Ausgrid is a good example of an issuer that has been focussed on finding market diversification along with right market, right timing approach. NAB has been fortunate to work closely with Ausgrid and has been involved with a number of their issues including their US private placement.

"Infrastructure projects and investments are expected to continue to be attractive prospects for multi-currency issuance options as population and communities expand particularly across the eastern corridor of Australia," she adds.

FINANCIALS IN FAVOUR

What is clear, however, is that while investors are eager to have Australian bonds in their portfolio - be it in US dollars, euros, Japanese yen, renminbi, Singapore or Australian dollars - shorter tenors are the obvious sweet spots. Generally, investors in the past have preferred exposure to longer tenors for the all-in yields they offer, but rate movements in the US, where the Federal Reserve is stepping up its pace of interest rate hikes, has driven interest for shorter exposures.

Of the 64 investors that responded to the question on their debt maturity preference, around 31% prefer bonds with tenors of less than one year, with 4.69% of the respondents saying their desire for these short term notes has changed over the last 12 months. An equal 23.44% of the investors opt for notes between one and three and three and five year maturities, while 17.19% of the accounts like five to 10 year notes. A paltry 4.69% of the investors have appetite for bonds of longer than 10 years.

When it comes to sectors, too, investors have some obvious favourites. Around 33.9% of the investors had upped their exposure to the financial institutions segment over the last 12 months, while the infrastructure sector recorded an increase of 26.92%, and utilities by 26.79%.

The preference for financial credits - senior and bank capital notes - is understandable. Australian banks' senior debt looks fair versus their international peers, while their tier two subordinated debt is also relatively attractive versus Asia Pacific regional and global peers, say analysts at CreditSights, an independent research provider. Australian

banks have been holding up well, with incidence of new impaired loans remaining low and credit quality trends staying benign.

On the flipside, the mining industry has lost its sheen. Australia's mining sector has come under immense pressure recently, with many saying the mining boom is over and the industry is losing its importance.

Investors appear to agree. About 20.75% of the respondents that look at the mining industry said they had taken a knife to their exposure to the sector - the steepest fall among all the different industries - while 71.70% saw no change.

When it comes to troubling elements of the Australian bond market, an impressive 42.11% of 72 respondents cited no concerns. But 35.09% pointed to insufficient secondary market liquidity, while investors also believe the issue size and the relative lack of high yield issuance in Australia are troubling.

There may be more challenges coming up ahead though, as Australia's 10 year bond yield dips slightly below the rate investors are being offered in the US Treasury market. Some 30% of the respondents to this question expect the spreads between the US and Australian market to rise further in the next 12 months, while 23.33% believe it will dip. Of the respondents predicting an uptick, around 32% said it will rise by 10bp to 20bp, while around 9% said it will jump by 0-10bp or by more than 25bp in the next year.

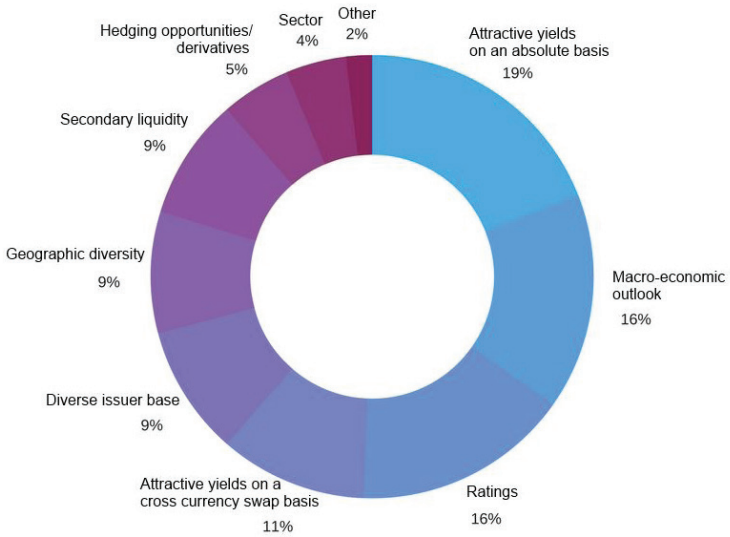
This could present some obvious challenges for investors' portfolio of Australian debt. The spread differentials between US and Australian bonds could force 16.13% of the 62 respondents to reduce their exposure to Australian dollar bonds, while 12.90% said they will increase their exposure. But the majority - or close to 71% - said the move will not change their appetite or exposure to the market.

"We continue to monitor long-end spread differentials, though financial Institutions particularly banks issue across tenors and currencies, says NAB's Fox. "Asian investor participation has continued to be strong in Australian financial and corporate issues and with Asian liquidity we do anticipate that investor appetite will continue to be to be supportive of Australian credit for some of the reasons noted earlier.

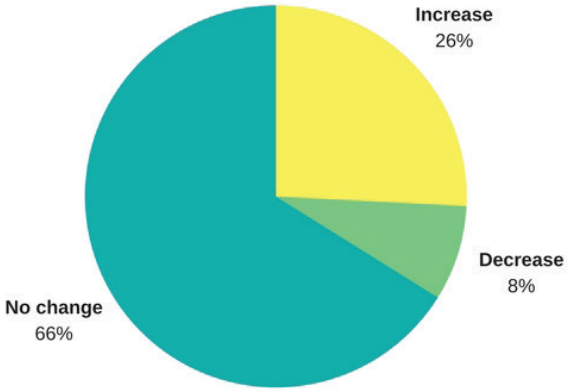
"Green and sustainable bond issuance from Australian borrowers, coupled with growing ESG investment interest from Asian investors, further supported by European and US investors, is an area banks and non-banks are diversifying, reaching new types of investors into their portfolio," says Fox.

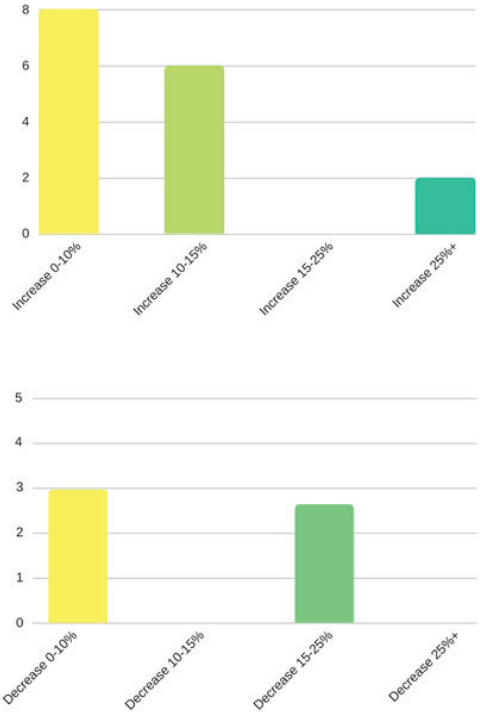
Needless to say, investment opportunities in Australia are rife for Asian and European accounts. Of the investors with less than 5% exposure to the Australian market now, nearly 15% are looking to boost their Australia portfolio in the next 12 months - a positive sign for the country's bond issuers. It's time they take advantage of that interest. ■

WHAT FACTORS DO YOU CONSIDER WHEN DECIDING WHETHER OR NOT TO INVEST IN A BOND MARKET?



ARE YOU PLANNING TO CHANGE YOUR EXPOSURE TO THE ESG BOND MARKET IN THE NEXT 12 MONTHS?

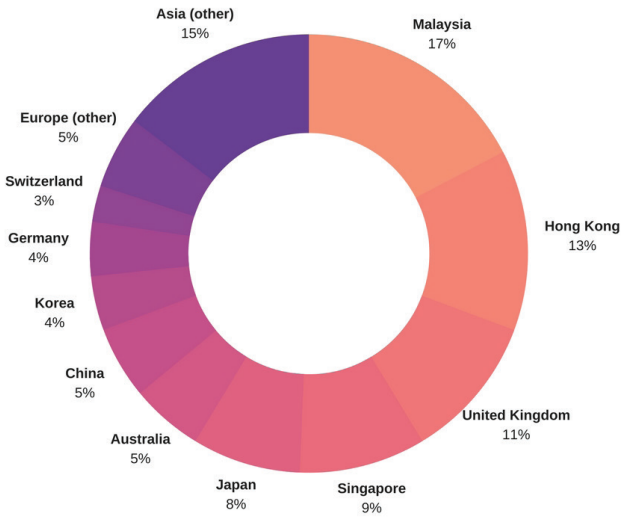




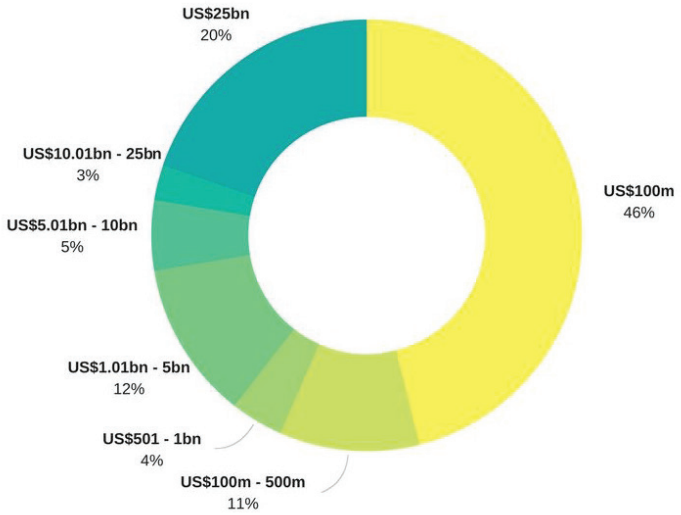
POLL METHODOLOGY

National Australia Bank and Asiamoney corresponded with a broad base of investors across Asia and Europe for the 2018 Australia Fixed Income Poll. Of the 76 investors who responded to the survey, about 71% were based in Asia and 22.3% in Europe, with the remaining handful located in Australia and the US. Even within Asia, there was plenty of diversity, with 17% of the investors coming from Malaysia, 13% from Hong Kong, 9% from Singapore and 8% from Japan. Investors in the poll also had different mandates. About 18.42% were banks and an equal number were corporations, while 11.84% were mutual funds. Hedge fund participation was 9.21%, while insurance companies and pension funds represented an equal 5.26% of the respondents. In terms of overall assets under management, about 46.05% of those surveyed had less than $100m, while 19.74% had more than $25bn. About 11.8% had assets of between $1bn and $5bn, while around 10.5% of the investors were managing between $100m and $500m. About 71.6% of the respondents had between 0% and 5% of their portfolio focusing on the Australian dollar bond market, while 12.16% had an exposure of between 5% and 10%. Around 10.8% had more than a quarter of their portfolio exposed to Australia while 5.41% had between 10% and 25% exposure.

WHICH COUNTRY ARE YOU BASED IN?



WHAT IS YOUR FIRM'S OVERALL ASSETS UNDER MANAGEMENT?



WHAT TYPE OF FIRM DO YOU WORK FOR?