ARDEA
Investment
Management

Bond issuance to underpin rising market opportunities

The Australian Commonwealth budget announcement overnight has confirmed the size and trajectory of the Australian government bond market. The Australian Office of Financial Management's (AOFM) updated issuance plans also indicate that bond supply will remain persistent. This acts to underpin capacity in the bond market for large investors seeking access to the asset class. Persistent issuance, in the face of ongoing regulatory and market distortions, is also likely to enhance opportunities for expert investors to add value through active management.

Bond market capacity and supply

The announcement from the AOFM confirms that the Commonwealth bond market's current size of over $525bn will remain largely unaffected by the current budget and forward projections. This provides a commitment to a market size which remains large enough to accommodate allocations from even very large institutional investors. Capacity constraints and concerns around market impact thus remain low.

In addition to the size of the market, AOFM also announced $70bn of gross new issuance over the coming financial year (2018-2019). This growth in supply over the coming year provides substantial accommodation for investors to grow existing allocations as their needs increase over time..

Moreover, the AOFM has also indicated weekly tenders of $1bn, providing confidence that supply can be accessed as required, without the need to align large flows to meet the timing of new primary issuance.

AOFM also announced the issuance of $5bn in inflation linked bonds (Treasury indexed bonds or TIBs) over the coming year, consistent with their objective to maintain a diverse range of investment options for investors.

Together these announcements help affirm the current depth and liquidity of the Commonwealth government bond market.

Rising scope to capture market inefficiencies

Maintaining Australia's current government bond market, both in terms of size outstanding and ongoing issuance, is occurring against a backdrop where the drivers of market inefficiencies are becoming ever more prevalent.

These inefficiencies include the rising burden of government regulation on major participants in the financial sector. Much of this has fallen on banks, and restrictions relating to capital charges, balance sheets, and proprietary trading continue to limit the ability of banks to make markets in bonds, and to take active positions.

The absence of these entities from the market has created greater opportunities for price discovery by active fund managers. Distortions in markets also tend to be larger and thus more profitable than previously. Increasing regulation of other financial institutions such as insurance companies is having a similar effect.

In addition to regulatory restrictions, the increasing market share of passive investment vehicles has also produced a new class of investors which are mandate-sensitive rather than price sensitive. This helps to create, and maintain, patterns of investor behaviour that leave value on the table for price-focused investors such as active managers.

These changes in issuance and persistent market inefficiencies are also taking place against a backdrop of declining global liquidity. The transition from quantitative easing some years ago, to quantitative tapering, and even tightening in some cases, has seen significant volatility in markets in recent months. With no expectation for liquidity conditions to ease given the strong commitment of central banks to withdrawing stimulus, this is likely to provide an ongoing source of market dislocation as well. This gives rise to additional opportunities to capture value from market inefficiencies.

Overall, this environment places Ardea well to continue to identify and exploit inefficiencies in fixed income markets and to generate consistent and differentiated returns uncorrelated to both bond and equity markets, without having to rely on duration or credit.

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May 2018