Precursor

On 3 October the RBA announced their decision to hold the Australian overnight cash rate unchanged at 1.5%. The announcement came with headline statements on contributing factors. The full minutes of the meeting were released according to normal schedule on 17 October.

a) What a difference a day makes

This full release coupled with September quarter CPI release led to bets on the rise in the ASX 30-day Australian Interbank Cash Rate Futures for August 2018 falling to 68%, down from 88% prior to the CPI announcement.

Financial intermediaries and commentators parse the language of these Central Bank statements looking for tactical advantages or better insights. You should treat such an exercise as a waste of your time.

This precursor is useful whether you are a first-time reader or repeat reader of Baillie Asset Management's communications.

b) What's Not a Waste of Your Time

Glenn Stevens, in his first major commentary on financial markets since retiring as Australia's Governor of the RBA, expressed deep concerns over complacency about the risks of a sharp rise in inflation.

We totally concur with Glenn's concerns to the extent that monitoring this is our highest priority on the six to twenty-four month time horizon.

We don't second guess our RBA, but the recent job data shows that the NSW reduction in unemployment is a tail wind to a sharp rise in inflation, but is counterbalanced largely by the head wind of 6% unemployment in Victoria and 5.7% in Queensland.

Complacency is measured by risk premiums and we concur that currently they are too low for the actual risk exposure.

We respect that you should never say never, but in the life expectancy of the subset of wholesale investors that this communication is most useful for, unconditional obligations of Australian Governments and Australian Banks can be treated as capital secure financial instruments.

There is a cost to owning capital secure financial instruments as will be evidenced later in this communication.

Australian Bank Hybrids are conditional liabilities of the issuing banks, and our identifier of "sophisticated savings" is designed to avoid confusion with "simple savings", which are the unconditional obligations of the issuing banks.

Bank Hybrids are the "bed rock" of a group of financial instruments we identify as capital stable.

In the last 18 months, the yield to maturity of long tenure bank hybrids has fallen over 35%. This creates a paradox evidenced in the table below.

Our Universe of Hybrids

ASX Code	Market Price	Theoretical Value	Variation from Theoretical Value	Yield to Maturity	Total Earnings	Maturity Date
MQGPB	$107.29	$101.09	6.13%	4.97%	7.06%	17-03-21
WBCPF	$104.32	$100.78	3.51%	4.55%	5.55%	22-03-21
CBAPE	$103.23	$101.08	2.13%	4.89%	6.83%	15-09-21
WBCPG	$107.50	$100.76	6.69%	4.77%	6.24%	20-12-21
AMPPA	$108.55	$100.93	7.55%	4.74%	6.39%	22-12-21
CBAPF	$102.30	$100.88	1.41%	4.97%	5.57%	31-03-22
NABPD	$100.65	$100.64	0.01%	4.87%	6.72%	07-06-22
SUNPF	$100.00	$100.99	-0.98%	4.93%	5.91%	17-06-22
CGFPB	$102.35	$101.36	0.98%	4.93%	6.10%	22-05-23
ANZPG	$107.02	$100.91	6.05%	5.27%	6.09%	20-03-24
BENPG	$100.00	$100.00	0.00%	5.39%	5.48%	13-06-24
SUNPG	$100.00	$100.00	0.00%	5.34%	5.37%	17-06-24
ANZPH	$102.70	$100.66	0.66%	5.18%	5.43%	20-03-25

*Theoretical Value = Face value + accrued interest

Following the three-question architecture that was introduced to readers in our 1 October 2015 edition of this communication, we were able to anticipate that supply of new issues of bank hybrids would revert to normality.

Normality

Normality exists when there are no extraordinary interventions in Total Loss Absorbing Capital ratios by the APRA. New issues reflect the refinancing of maturing securities, either at the first call date or the second call date of the hybrid, and any additional capital needed for corporate growth earnings targets. The Bendigo Bank Issue announced on 16 October 2017 reflects this normality.

Although the logistical possibility of additional demand driven by institutional involvement existed from 1993, we were unprepared and surprised by Uni Super, one of Australia's largest super funds, breaking the mould in February 2016 that hybrids were solely a retail financial product.

It was surprising, given ASICs chagrin that Bank Hybrids were unsuitable to be retail financial products, that this did not happen much earlier.

Since 15 September, starting with the announcement of the ANZ Banks decision on its ANZPH issuance, there have been a number of independent but relating events.

Our RBA holding interest rates steady for 13 months in a row is one of these events, with the market pricing of no change for a further 7 months.

The objective of gaining clear insight into the relative import of these independent events, is the impact on how contented you can afford to be about your capital position.

Before sharing the events and our insights, we will re-assess the current position with our three contentment questions first tabled on 1 October 2015.

Three Questions

Q.1 What are those you can trust up to?

It speaks volumes that not only did Dr. Guy Debelle do his PhD at MIT on the topic of "How Independent should a Central Bank be?", but that his supervisor was also Stanley Fischer, who is about to retire from the US Fed.

Twenty years after their joint paper was published, Guy Debelle, who will replace Phillip Lowe in just over 8 years' time as our next RBA Governor, was asked to speak by the Bank of England at its twenty-year anniversary of England's central bank independence.

However, from a practical point of view, it is APRA that is having most influence on your capital contentment. Once the four major banks plus Macquarie were seen as capable of meeting the deadlines for restoration of the level playing ground for risk weighting of residential mortgages, the "too big to fail" regime was announced.

On 19 July 2017, APRA nominated that the major banks need to have Common Equity Tier 1 (CET1) ratios of 10.5% by 1 January 2020.

At least 3 out of the four banks have achieved this already.

For the foreseeable future those you trust have really done what is needed to be done for Australians to enjoy remarkable Financial Stability. This has been reinforced with the recent RBA announcement of their stress testing of the Australian banking system. We see no need to continue to include this question in the contentment architecture for the foreseeable future.

Q.2 Has the reduction of negative impacts from the GFC in the US continued to shrink?

The approximate source of funding for Australian bank assets is 60% domestic deposits, 30% wholesale institutional loans and 10% equity.

Whilst the crisis of the GFC is unlikely to be repeated, there will be different crises that will impact on the cost of the 30%. The Federal Reserve ensured our banks had the liquidity during the GFC so availability of funding is not an issue. Price can be. Hence the basis of the second contentment question.

As reported in our July 2017 communication, the 34 US banks considered "too big to fail" all passed their stress tests and have increased sovereignty over some of the $750 billion additional capital amassed by those banks since 2011.

This bodes very well for the extremely modest $60 billion per quarter of QE shrinkage that starts this month.

The basis of the September Federal Open Market Committee (FOMC) decision to leave the range of overnight cast rates unchanged is well evidenced in the table on the next page.

Economic projections of Federal Reserve Board members and Federal Bank presidents under their individual assessments of projects appropriate monetary policy, September 2017. Advance release of table 1 of the Summary of Economic Projections to be released with the FOMC minutes.

	Median				
Variable	**2017**	**2018**	**2019**	**2020**	**Longer Run**
Change in real GDP	2.4	2.1	2.0	1.8	1.8
June projection	2.2	2.1	1.9	n.a	1.8
Unemployment rate	4.3	4.1	4.1	4.2	4.6
June projection	4.3	4.2	4.2	n.a	4.6
PCE inflation	1.6	1.9	2.0	2.0	2.0
June projection	1.6	2.0	2.0	n.a	2.0
Core PCE inflation	1.5	1.9	2.0	2.0	
June projection	1.7	2.0	2.0	n.a	
Memo Projected Appropiate Policy Path					
Federal funds rate	1.4	2.1	2.7	2.9	2.8
June projection	1.4	2.1	2.9	n.a	3.0

The critical element was the downwards revision of the 2018 Personal Consumption Expenditures (PCE) forecast from the June forecast of 2.0% to 1.9% in September.

So, despite the absence of real disposable income growth in the US over the last twenty-five years, we are now firm of the view that the GFC negatives are flushed out of the US financial system and the US is back on Terra Firma.

Importantly, the latest new equity Tier 1 issue by Westpac was a first-call ten-year US raising that was 0.52% p.a. cheaper than the latest domestic issue of ANZPH priced at a 3.8% margin above the 90-day Bank Bill rate.

For this reason, we can suspend this question from the contentment agenda, unless the student loan fiasco in the US or the unfunded pension and Medicaid liabilities push the US to a “Minsky Moment”.

Q.3 What are the Banks trying to do to us?

Given the content of earlier editions we see deja vu at the Australian Bankers Association (ABA) trying to have APRAs powers on Bank Executive Accountability Regime (BEAR) restricted.

Obviously, the Commonwealth Banks transgression with the 53,000+ missing AUSTRAC reports validates the regulators findings that there is a structural, cultural malaise in the Australian banking system. This is further reinforced by Westpac’s recognition that they need to pay compensation to 200,000 Premier Advantage customers for charging for non-delivery of services and benefits since 2010.

Fortunately, the insistence on Transparency, Governance and Clarity that is permeating everywhere is most useful in our banking system. Fintech will be a great facilitator and the very self-interested technology thrust of Macquarie will leave us all more empowered.

This question is now redundant, not only because of the active developments of financial stability insisted on by our regulators, but also because of the public theatre facing the Commonwealth Bank.

Independent but Related Events

We identified earlier that the RBA holding the overnight cash rate steady for 13 months in a row as one of the independent but related events. The others we believe noteworthy are.

1) **ANZ 15 September announcement**

Baillie indicated a wish to apply for $10 million of the ANZPH issue to replace the ANZPCs on its first maturity. There was no broker issue as the guaranteed applicants and the preferred applicants took up $930 million of the $1 billion ceiling the ANZ had announced.

Insight: With CET1s at levels scheduled for a 1 January 2020 mandate, owning first call issues about to be decided on, protects your access for at par issuance. But don't pay a premium or lose franking credits!

2) **FOMC 20 September decision**

For the second year running, the US has not raised interest rates at the pace advised at their respective previous December meeting.

Whilst the FOMC has a dual mandate, based on its forecasts it provides a "ceteris paribus" opinion that the markets can play with. In 2013, when reversal of QE was first mooted, the market's over-reaction led to a recognition that the FOMC has to use "softly, softly" methods.

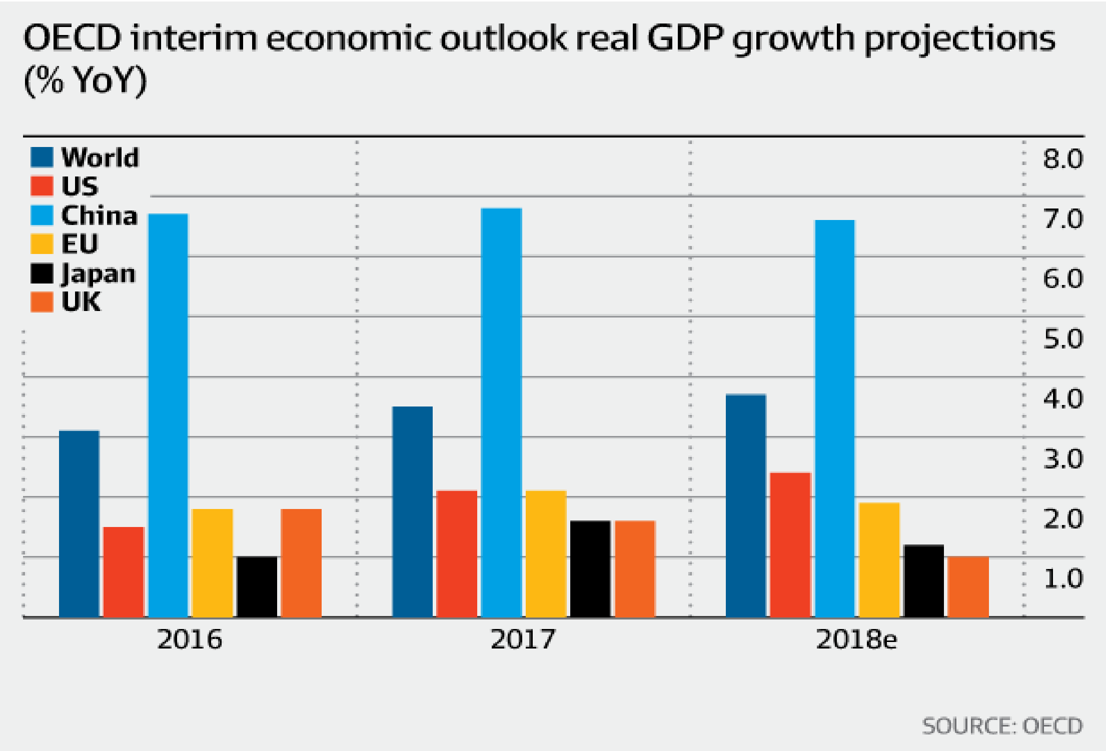
Insight: The commencement of the QE reversal at $40 billion per quarter to government bonds and $20 billion per quarter for mortgaged bank securities shows that you need not fear a liquidity shock, particularly in the US bond markets.

This increases the probability that the deserved deflation of asset prices will not cause a stampede, where deserving asset prices are collaterally damaged.

3) IMF Revisions

In their World Economic Outlook, the International Monetary Fund upgraded the economic growth rates for 2017 and 2018.

We have attached one of their tables from that Outlook that we believe to be the most relevant.



Insight: For the first time in many years, there is synchronised economic growth globally. Whilst indicators tend to the negative in the mid-term, the synchronicity of coincident growth provides the means to reverse this mid-term expectation and the time to introduce more productive policies.

4) US Housing

CoreLogic released their Negative Equity report for Q3 of 2017 on 11 October. Negative equity fell from 5.4% to 4.5%, with 3.1 million homes affected, or 6.1% of the 63% of mortgaged homes. One year ago, it was 4.1 million homes, representing 8.1% of mortgage homes.

Insight: US mortgage bank securities and home lending banks are becoming more robust every month with only Arkansas and Louisiana being the exceptions.

5) Gonski intervention in BEAR

Currently the proposed legislation leaves no right of appeal and this absence of right is the basis of the ABA claiming draconianism. The BEAR was the alternative to a Royal Commission on banking.

Insight: Westpac's generosity of lower simple account fee charges, the Commonwealth's voluntary removal of ATM fees, and the adoption of same by the others within a day is just part of the transparency, governance and clarity the banks have no choice but to pro-actively adopt.

6) Helen Rowell, APRA Deputy Chairman at her Senate appearance to improve governance, transparency and members' outcomes in Australian Super

RG97 improves clarity on public offer funds that led Aus Super to declare a minor increase in their annual investment management cost to members to 0.74% p.a.

Insight: In time you will be able to truly compare not just "apples with apples" but "type of apple" with the same "type of apple". The asymmetry of information and knowledge, the source of much abuse in financial services, is nearing an end.

Capital Stable Update

Whilst banks do offer Covered bonds, where lenders get both security and a guarantee, for either simple savings or sophisticated securities we believe the security is overkill.

However, the security must be a cornerstone for all other capital stable issues.

There are three tax rates applicable to wholesale investors: nil, 15% and 27.5%. With an annual trailing inflation rate of 1.8% and a 90-day bank bill rate of 1.75%, short duration simple savings cause a permanent loss of capital to the owner. This is the cost we alluded to on page 2 of this communication.

Regardless of which of the three tax rates apply, sophisticated savings produce a real return.

The table below details the trade-off for the capital stable funds inherently involve.

	Baillie Sophisticated Savings Fund	**Baillie Incontestable Invoice Financing Fund**	**Baillie SMSF Lending Fund**	**Baillie Conservative 1st Mortgage Fund**
Supply	Unconstrained	Irregular due to difficulty of sourcing high credit quality invoices.	Depends on take up on preapproved applicants	Depends on bank behaviour and competitive stance of other shadow banking participants.
Liquidity	Within 3 days	Mid-term liquidity (up to 90 days)	Insufficient history on advanced prepayments to be accurate	Mid to long term (90 days to 12 months)
Tenure	Mid to long term (typically 4 years to 7.5 years)	No guaranteed tenure (90 days maximum)	Mid-term (expected Average 4 years Term Exposure)	Short term (1-year maximum)
Inconvenience Exposure	Currently minimal and simple to clarify.	Low	Very Low	Low
Expected Receipted Earnings	4%	7%	8%	7.5%
Expected Refundable Earnings	1.5%	1%*	0%	0%
Expected Total Earnings Compared to Capital Secure	3.2% above	5.7% above	5.7% above	5.2% above
Additional Reward for Inconvenience	Potential purchase of equity earnings at a deep discount. Very low material relevance	Up to 4% penalty interest payable if issuer doesn't pay on-time. Low material relevance.	Up to 4% penalty interest payable if interest is not paid on time or principal obligations are not met. Low material relevance	Up to 6% penalty interest payable based on either the lack of timely interest payments or the failure to meet maturity. Medium material relevance

* How much money is receipted or refundable is an estimate based on our current experience

Summary

Some weeks ago, one tenderer in the weekly Treasury bond tender took up 100% of the $800 million 12-year maturity issue by outbidding all rivals.

The same happened for the 21 December 2021, 2% coupon $600 million tender two weeks ago. Despite a coverage ratio of 7.48 times the offer and 41 bidders, one knockout bid scooped the pool. At the winning yield of 2.3225%, only super funds would not lose capital, unless interest rates fall to produce a capital profit to compensate for the 0.12% real loss.

Expect to see volatility and illogicality as the QE rescission impacts on us all. Your best defence is knowing which trade-offs you can afford psychologically.