PORTFOLIO COMPASS

Credit and Fixed Income

September 2024

Executive summary

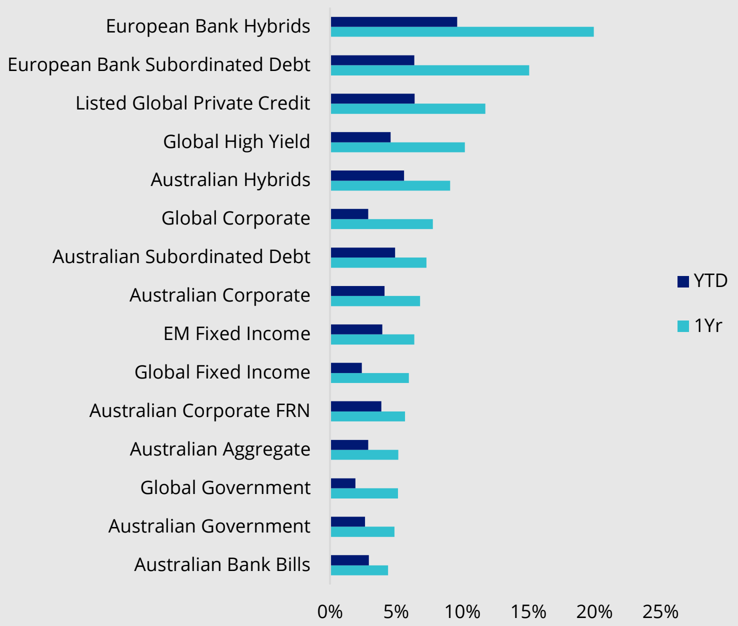
If the past 12 months taught investors anything, it's that being selective and diversified is key to riding the economic cycle. Had investors avoided risk assets on the back of many economists calling the "most anticipated recession" that never happened, they would have missed the stellar markets run led by higher yielding fixed income asset classes.

Looking ahead, VanEck's latest portfolio compass dissects our observations on inflation, policy rates, economic growth, exogenous risks and exposures considerations.

In Australia, credit spreads may tighten due to favourable market dynamics, particularly in subordinated debt. Extending portfolio duration becomes increasingly attractive as the Reserve Bank of Australia (RBA) edges closer to an easing cycle.

Globally, seeking quality exposures is prudent in a tight spread environment. Striking the optimal balance between yield enhancement, diversification and managing volatility is essential to navigate these conditions effectively. This approach ensures that portfolios are well-positioned to capitalise on opportunities while mitigating risks associated with market fluctuations.

Credit and fixed income performance as at 31 August 2024



Source: Bloomberg, 1 September 2023 to 31 August 2024, returns in Australian dollars. Global Corporate is Bloomberg Global Corporate Bond Hedged AUD Index, Australian Bank Bills is Bloomberg AusBond Bank Bill Index, Australian Aggregate is Bloomberg AusBond Composite 0+ yrs Index, EM Fixed Income is 50% J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD and 50% J.P. Morgan Government Bond-Emerging Market Index Global Diversified, Australian Corporate FRN is Bloomberg Ausbond Credit 0+Yr FRN Index, Global High Yield is Bloomberg Global High Yield Index. European Bank Hybrids is Bloomberg European Banks CoCO Tier 1 Hedged AUD Index, European Bank Subordinated Debt is Bloomberg European Banks CoCO Tier 2 Hedged AUD Index, Australian Hybrids is Solactive Australian Hybrid Securities Index, Australian Corporate is Bloomberg AusBond Composite 0+ yrs Index, Australian Subordinated Debt is iBoxx AUD Investment Grade Subordinated Debt Mid Price Index, Australian Government is S&P/ASX Government Bond Index, Global Government is Bloomberg Global Treasury AUD Hedged Index, Global Aggregate is Bloomberg Global-Aggregate Bond AUD Hedged Index. Past performance is not a reliable indicator of future performance.

Global macro observations

The pace of US disinflation may accelerate

- The unwinding of services inflation may accelerate with unemployment near the non-accelerating rate of unemployment (NAIRU).

Shallow US easing cycle

- The market's optimism for substantial rate cuts in 2024 appears excessive.

Australian rate cuts seem a distant prospect

- 'Services' inflation remains persistent, with business costs picking up speed again.

Exogenous risks

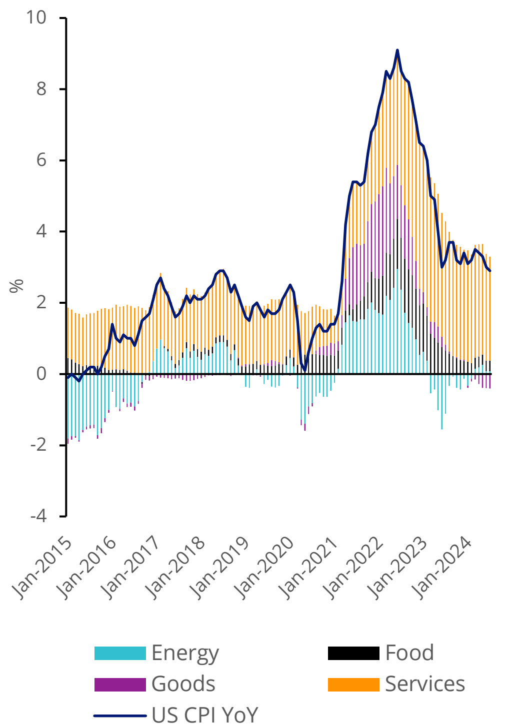
- US government debt trajectory could push long term yields higher.

The pace of US disinflation may accelerate

USA: The unwinding of services inflation may accelerate with unemployment near the non-accelerating rate of unemployment (NAIRU)

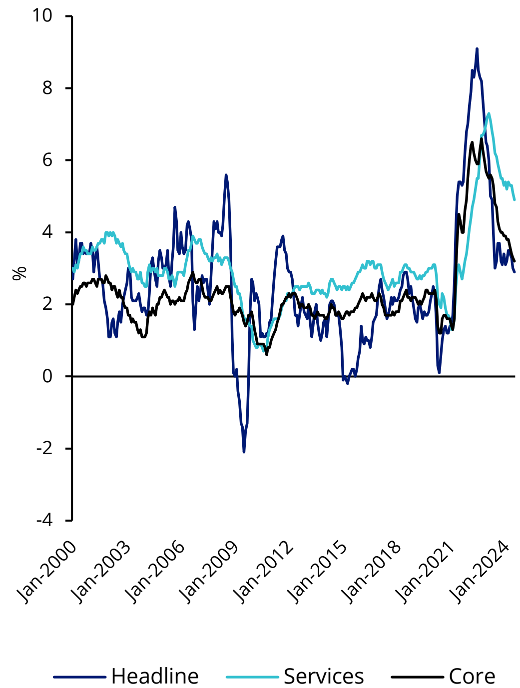
US CPI year on year contribution

Services contribution ~1.5x above pre-COVID trend



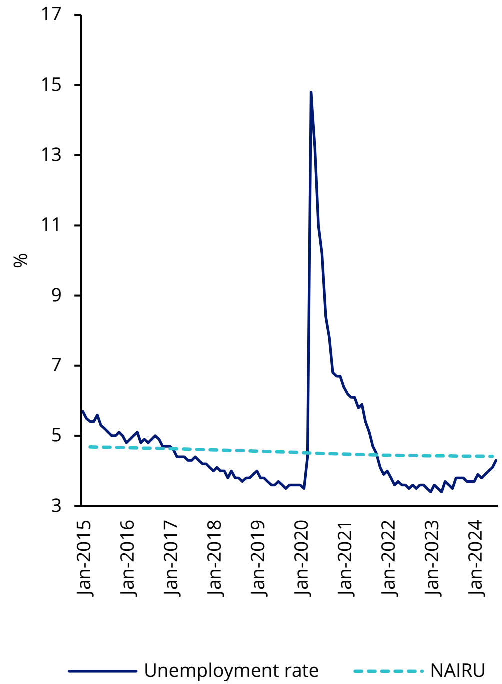
US CPI year on year

Slow burn to unwind services inflation



US unemployment rate

Near the non-accelerating rate of unemployment



Non-Accelerating Inflation Rate of Unemployment (NAIRU) : Theoretical measure that indicates the lowest unemployment rate that can be sustained without causing wages growth and inflation (notably services) to rise unsustainably.

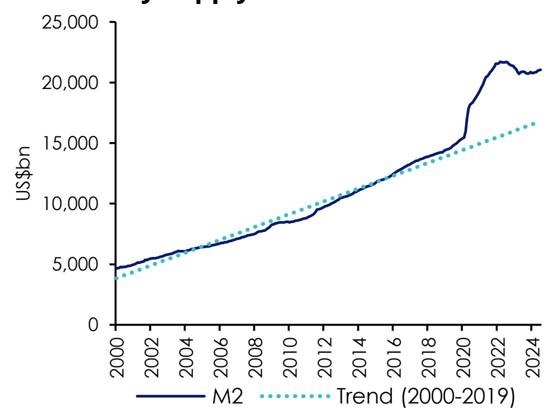
Source: Bureau of Labour Statistics. Federal Reserve Bank of St Louis.

Shallow US easing cycle

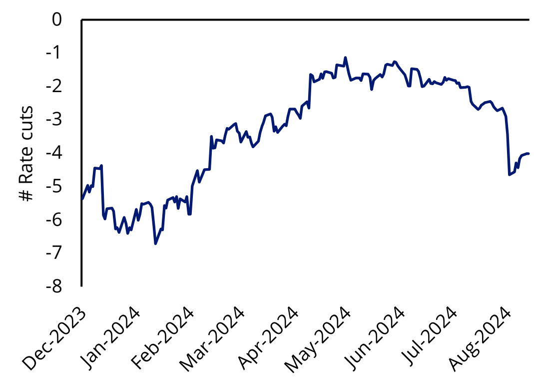
USA: The market's optimism for substantial rate cuts in 2024 appears excessive

- The market anticipates substantial rate cuts by December 2024, driven by ongoing concerns about a potential US recession, especially in light of recent weaker jobs and manufacturing data.
- However, fears may be exaggerated and a shallow easing cycle may be true for several reasons.
- While services inflation is moderating, the robust state of the US economy appears well positioned.
- Excess liquidity, loose financial conditions, and substantial fiscal spending may continue to support economic growth and drive demand-side inflationary pressures.

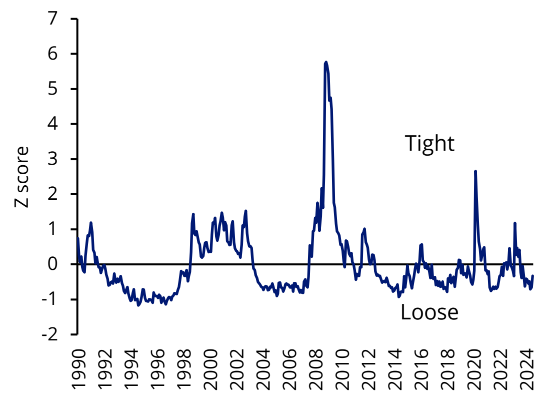
M2 money supply



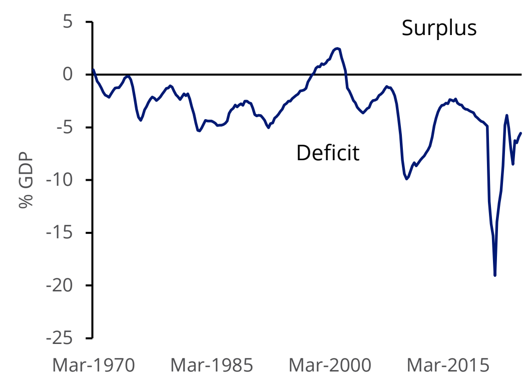
Rate cut market consensus by Dec 2024



Financial conditions



US Budget balance (% of GDP)



Source: Bloomberg, Federal Reserve Bank of Chicago, Federal Reserve.

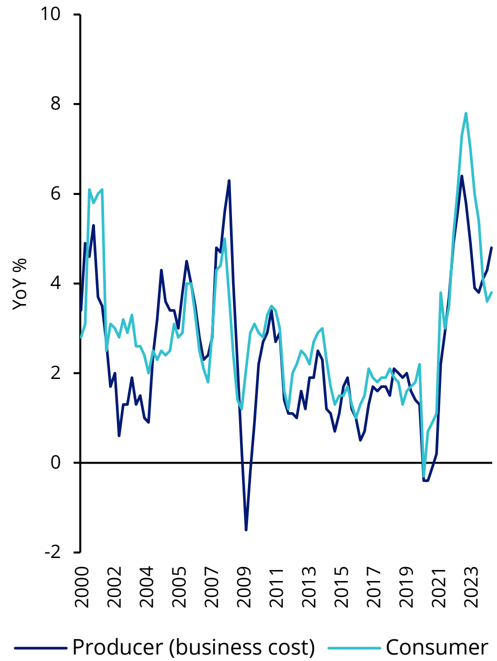
Australian rate cuts seem a distant prospect

Australia: Services inflation remains persistent, with business costs picking up speed again.

- Inflation has reaccelerated, and there is a higher risk that the RBA increases versus decreases the cash rate this year.
- Persistent services inflation remains unresolved in Australia – something that the US appears to have successfully moderated.
- Stage 3 tax reductions and additional subsidies, which came into effect on 1 July, along with the wealth effect from rising property prices plus strong equity markets, could potentially elevate consumer spending and prolong the return to the RBA's inflation target band.
- Low unemployment provides the RBA with the ammunition required to increase the cash rate should they feel necessary to aggressively dampen demand-side inflationary pressures.

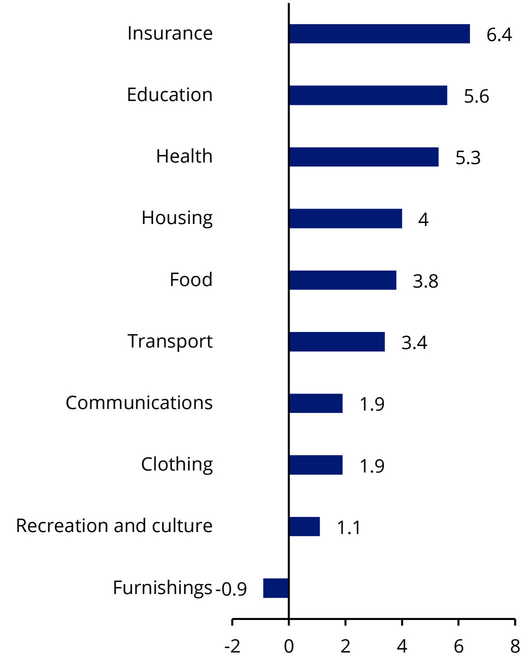
Inflation year on year

Consumer and business inflation has reaccelerated



Inflation year on year breakdown

'Sticky' services components elevated



Source: ABS.

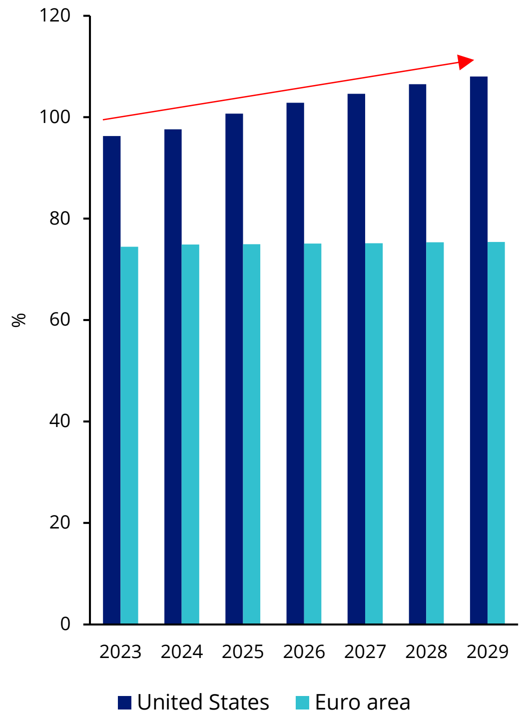
Exogenous risks

US government debt trajectory could push long term yields higher

- The ratio of US government debt to GDP is at an all-time high and is predicted to rise further, driven by expenses related to demographic shifts, the transition to a net-zero economy, and the upkeep of welfare programs.
- There's a slight possibility that the bond market may begin to seek a risk premium to offset growing doubts about the US government's debt servicing capabilities, potentially pushing up long term government bond yields.
- Major economies are not exempt from financial distress, as evidenced by the surge in government bond yields for Italy and Spain during the Eurozone crisis. This spike was a result of both nations grappling with refinancing debt challenges after an abrupt halt in foreign investment, which necessitated dependence on outside aid from the ECB and IMF.

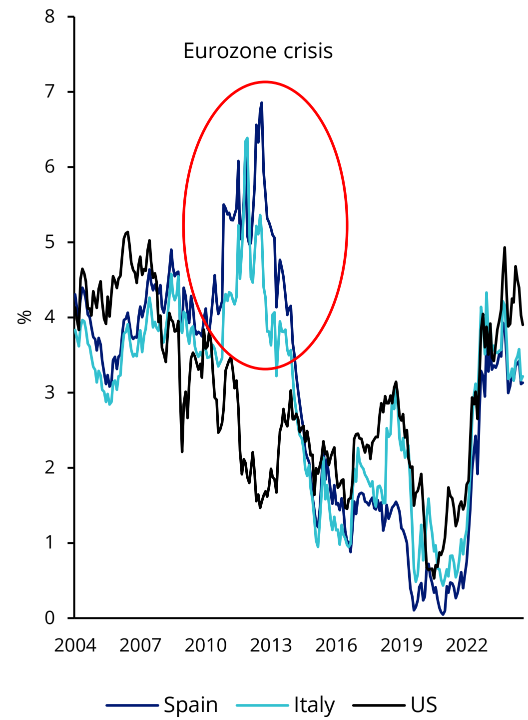
Government debt - % of GDP

US debt at all time high and forecast to increase



10 year government bond yields

Italy and Spain yields surged during the Eurozone crisis



Source: IMF, Bloomberg.

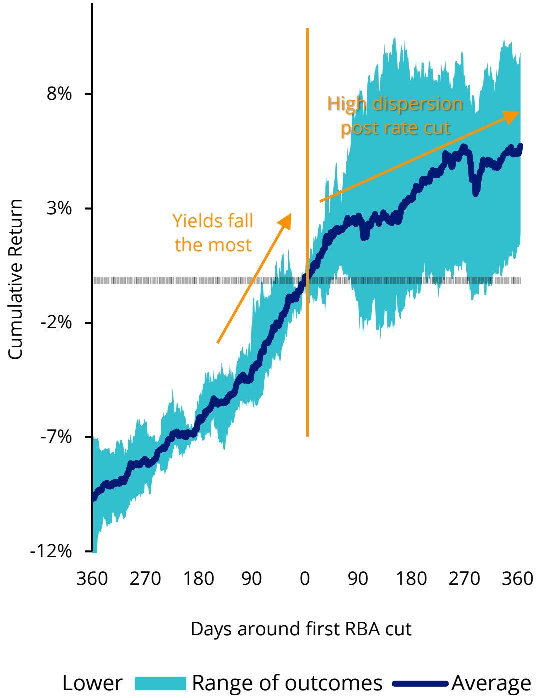
Credit and fixed income observations

Australian Government	Australian Semis	Australian Corporate
Australian Subordinated Debt	Australian Hybrids	US High Yield
Global Listed Private Credit	Emerging Market Debt	Global Hybrids

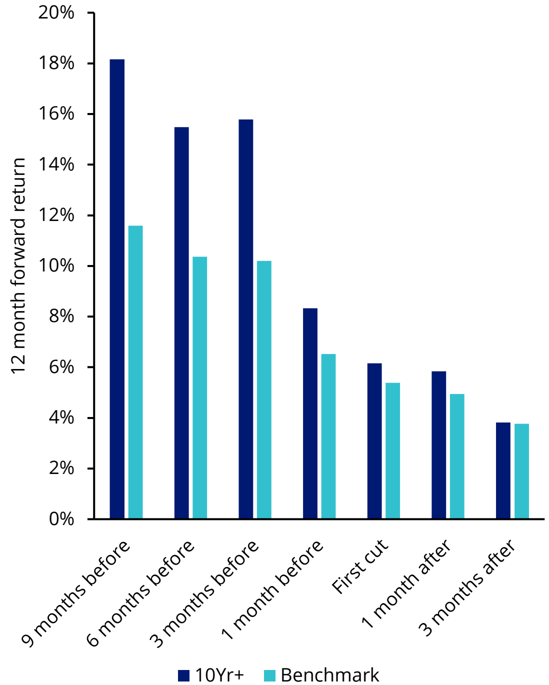
Australian government bonds

Extending portfolio duration increasingly attractive. Bond investors rewarded for pre-empting rate cuts.

Australian government bond performance around first RBA cut
Sweet spot historically 90 days prior to the first rate cut



12 month forward return around first RBA rate cut
Long dated bonds outperform



Key observations

- Extending portfolio duration becomes increasingly attractive as the RBA approaches an easing cycle, even if it appears a distant prospect.
- Additionally, this strategy serves as a crucial defensive measure, allowing investors to benefit from falling government bond yields should economic conditions unexpectedly deteriorate.
- In the past, bond investors have been rewarded for anticipating rate cuts, with long-dated bonds experiencing the most upside.
- The optimal timing for this upside has typically been around 90 days before the first rate cut, when yields tend to significantly decline.
- However, it's worth noting that performance outcomes have shown higher dispersion after the initial rate cut.

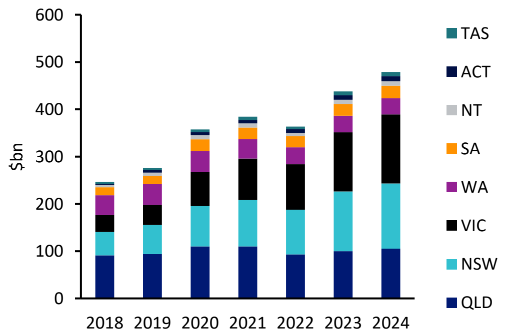
Source: Bloomberg, Benchmark as S&P/ASX Government Bond Index, 10Yr+ as S&P/ASX Government Bond 10Yr+ Index. Rate cuts include 6 February 2001, 2 September 2008, 1 November 2011, 3 February 2015 and 4 June 2019.

Australian semi-government bonds

Wider spreads commensurate with ballooning supply

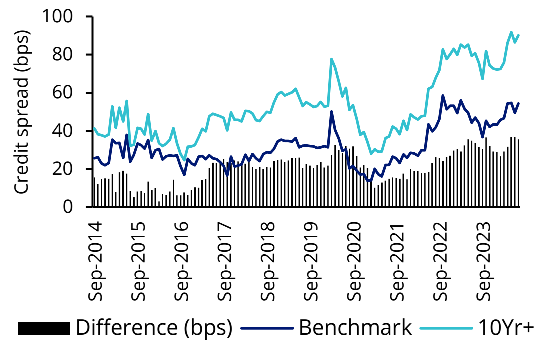
State government debt outstanding

Victoria and NSW have contributed ~80% of the total net issuance since 2020



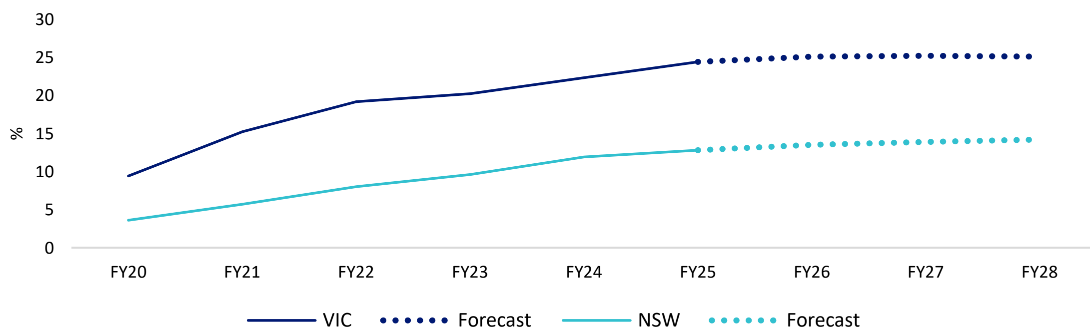
State government credit spread

10 year high



State government net debt to GDP

Five times higher than pre-COVID levels



Key observations

- The semis market has grown twofold in the last five years, reaching $500 billion. The COVID-19 pandemic led to a significant increase in debt, mainly due to extended lockdowns in Victoria and New South Wales.
- The rise in issuance has pushed spreads to their highest levels since the global financial crisis, particularly for long-term bonds. Such a trend is considered appropriate in light of the rise in government debt compared to GDP.

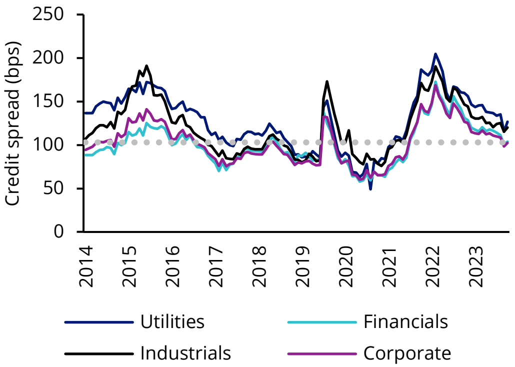
Source: Bloomberg. Benchmark as Bloomberg Ausbond Semi-Govt 0+ Yr Index, 10Yr+ as Bloomberg Ausbond Semi-Govt 10+ Yr Index,

Australian investment grade bonds

Tighter for longer spread regime. Yield attractive relative to equities.

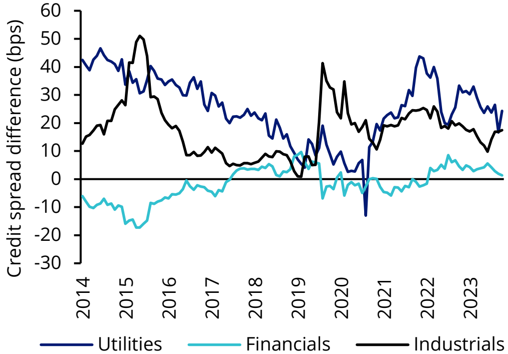
Credit spread by sector

Composite at historical average



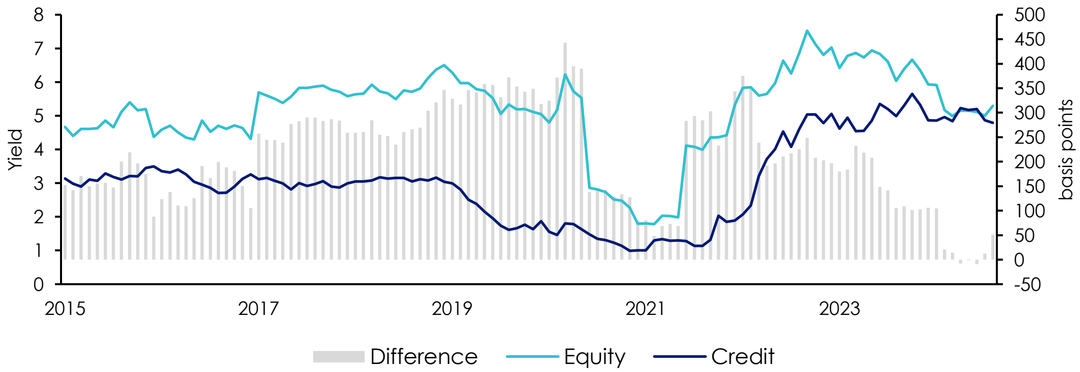
Credit spread differential

Top 3 largest sectors provide a yield pickup relative to benchmark



Credit yield to maturity versus S&P/ASX 200 earnings yield

Differential low



Source: Bloomberg Ausbond Credit Sector Indices.

Key observations

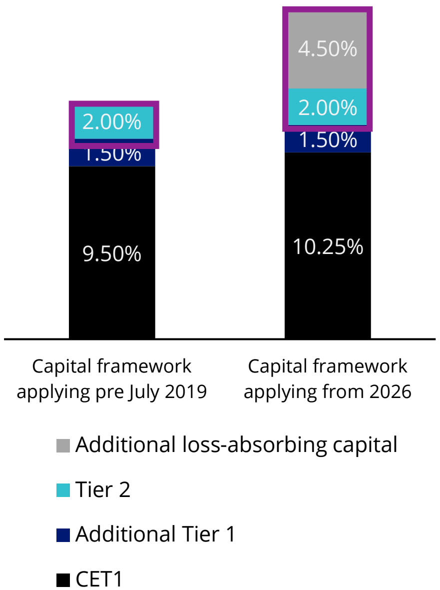
- Solid credit fundamentals, supportive economic backdrop and healthy credit demand may contribute to a marginal narrowing of credit spreads.
- Bank spreads are slightly above the historical average, offering relative good value. Capital requirement increase in the lower tranches in response to regulatory changes reduces the potential risk of loss on unsecured paper.
- Credit attractive relative to equities as gap between equity earnings yield and yield to maturity is narrow.

Australian subordinated debt

Market capitalisation has grown following APRA increasing big 4 bank Tier 2 capital requirements.

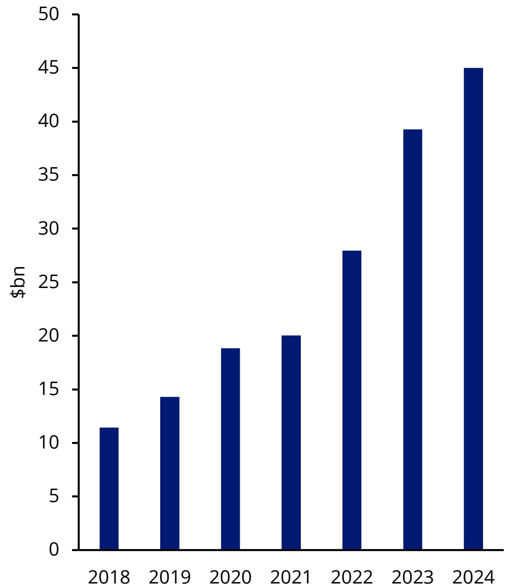
APRA's TLAC framework for Australia's big 4 banks

Tier 2 capital requirement increased from 2%



AUD Tier 2 market capitalisation ($bn)

Quadrupled over the 5 years



Key observations

- The Australian Prudential Regulation Authority (APRA) increased the Tier 2 capital requirement buffer for Australia's big four banks on 9 July 2019 and 2 December 2021. The latest measure will take effect from January 1, 2026, specifically raising the Tier 2 capital requirement from 2% to 6.5% of Risk-Adjusted Assets (RWA).
- These higher capital requirements were implemented to ensure that, in the event of a large or complex bank failure, it can be resolved with minimal impact on critical functions such as deposit-taking and payments.
- As a result of this announcement, AUD Tier 2 market capitalisation has quadrupled over the past five years, reaching over $42 billion.
- Amid market growth and favourable lending conditions, offshore banks such as Lloyds, HSBC, and Banco Santander have entered the market by issuing Tier 2 AUD paper to accommodate local demand.

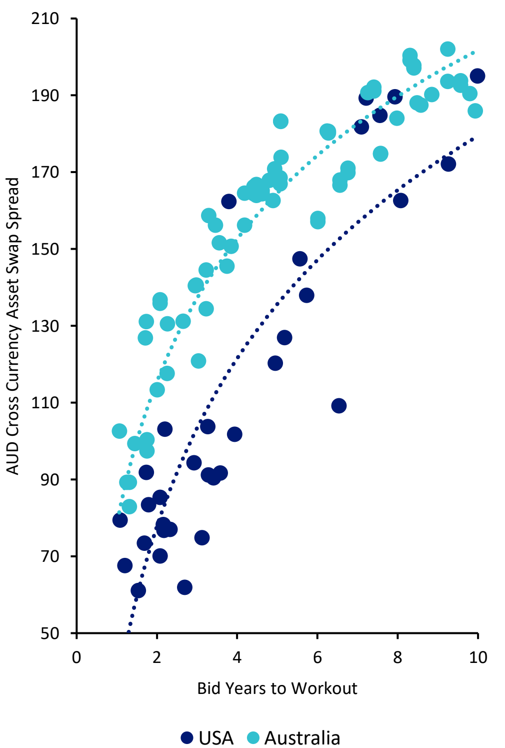
Source: Bloomberg, APRA.

Australian subordinated debt (Tier 2)

Credit spreads may tighten due to favourable market dynamics

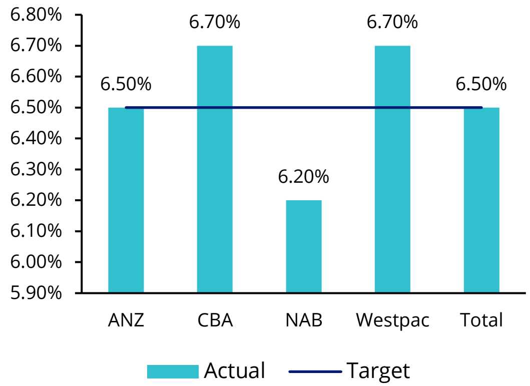
Tier 2 A- rated major bank credit spread comparison

Australian banks offer 20bps yield pickup relative to US banks



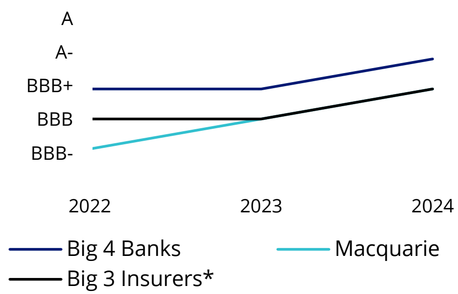
Tier 2 as % of Risk Weighted Assets (RWA)

Big four banks have reached APRA's Tier 2 target effective 1 January 2026



Tier 2 credit rating

Rating upgrades



Key observations

- The growth in Tier 2 market capitalisation and strengthening of bank and insurance capital buffers have contributed to improved credit ratings over the past few years. Further, single A 4 big bank credit rating has expanded the investable universe for many fund managers.
- High issuance year-to-date has enabled Australia's major banks to meet APRA's T2 target of 6.5% of risk-weighted assets (effective from January 1, 2026).
- Future issuance is expected to be on a replacement basis as existing bonds are called.
- Credit spreads may tighten due to strong investor demand, limited excess supply and yield pickup relative to comparable US bank A-rated subordinated bonds.

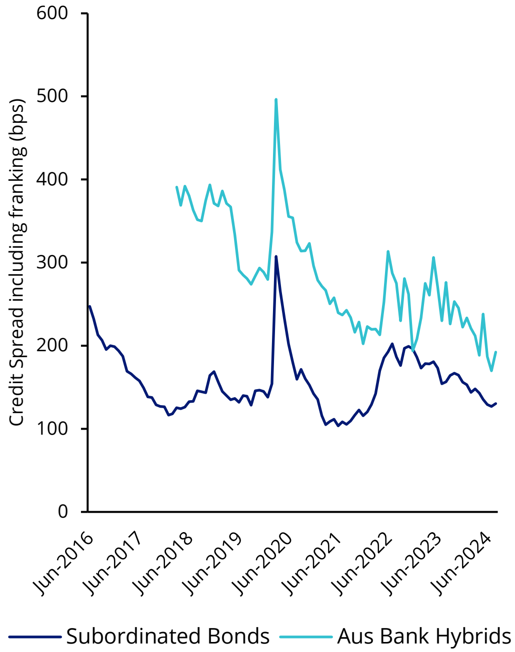
Source: Bloomberg, Company reports. Bloomberg composite credit rating. *Big 3 Insurers includes Suncorp, IAG and QBE.

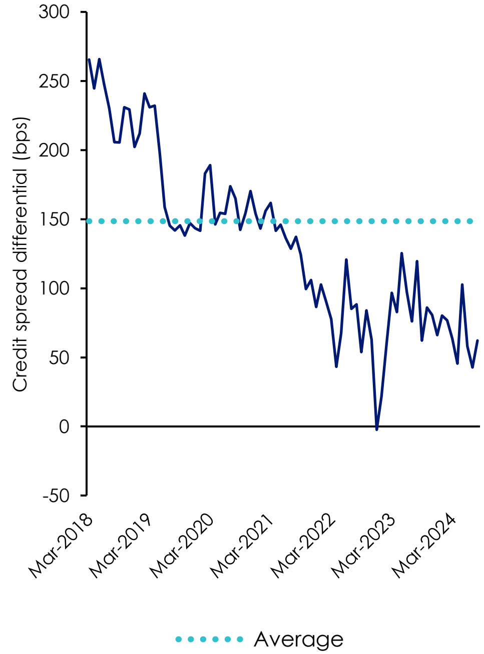
Australian hybrids (AT1)

Appears expensive relative to subordinated debt

Australian bank hybrids versus subordinated debt credit spread differential

Bank hybrids spread below pre-COVID lows





Key observations

- APRA is nearing the release of its consultation paper on ASX bank hybrids.
- Speculation indicates that APRA might mandate newly issued hybrids to be over-the-counter (currently exchange listed), thereby limiting access to retail investors. Additionally, new hybrid types with higher equity-conversion probabilities may potentially compel issuers to offer more attractive spreads on these securities, resulting in spreads on existing hybrids widening.
- We see better value in subordinated debt. Both instruments offer a similar yield (~55bps difference including franking), despite subordinated debt being higher up the bank capital structure. The yield differential is also below its historical average.

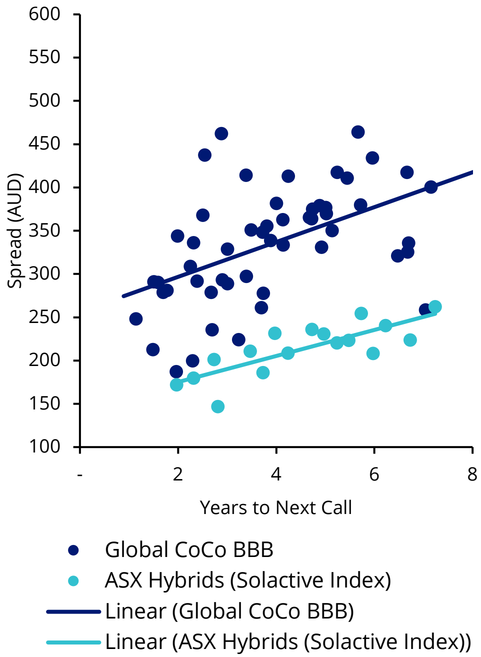
Source: IHS Markit, Bloomberg and VanEck; Subordinated bonds is the iBoxx AUD Investment Grade Subordinated Debt Mid Price Index; Aus Bank Hybrids is an equally weighted basket of Westpac, ANZ, NAB, Macquarie and ANZ Additional Tier 1 Capital Securities live from March 2018. Past performance is not indicative of future performance.

Global hybrids

Offer yield pickup relative to Australian hybrids

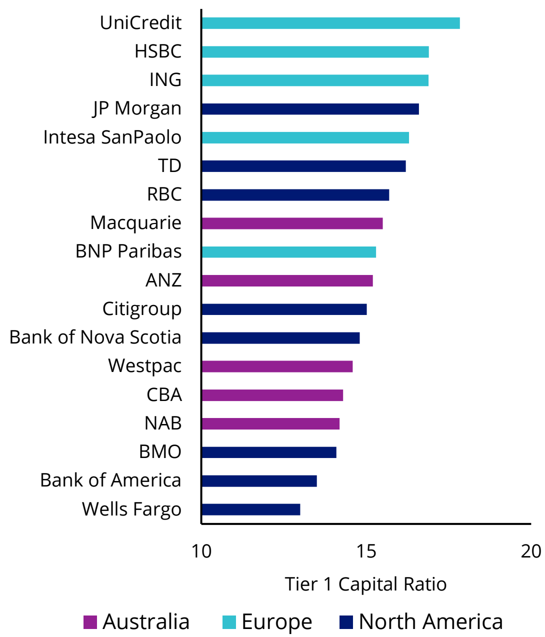
BBB Australian versus Global bank hybrid credit spreads

150 basis points yield pickup



Tier 1 capital ratios

US and Europe comparable to Australia



Key observations

- Global hybrid securities, which include instruments like contingent convertible bonds (CoCos) and other hybrid capital instruments, are an important part of the banking capital structure. These securities are designed to absorb losses during times of financial stress, providing a buffer to protect the core capital of banks.
- US and European bank hybrids provide a 150 basis points higher yield compared to Australian bank hybrids, despite offering similar Tier 1 capital ratio buffers.

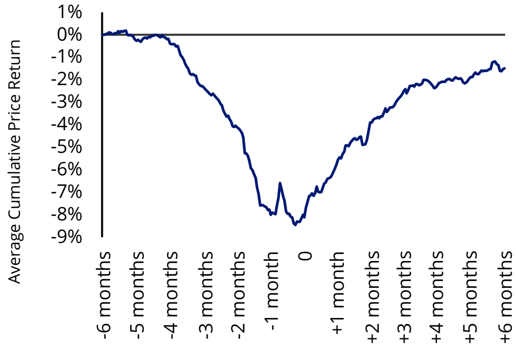
Source: Bloomberg, ASX, Bentham, Bloomberg.

US high yield

'Fallen angel' higher quality bonds typically outperform through tighter spread environments

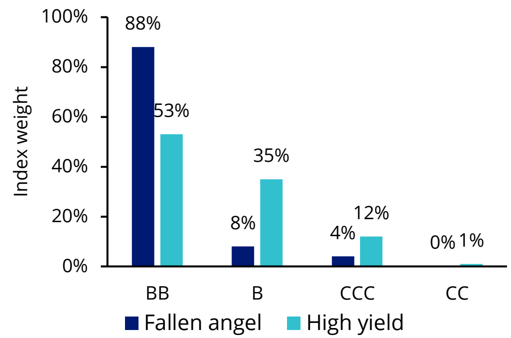
Fallen angel performance around bond inclusion

Typically rally post credit rating downgrade



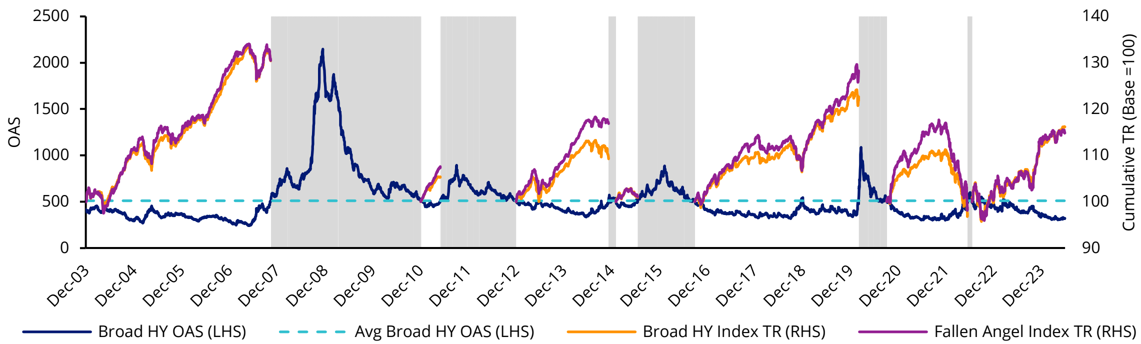
Credit rating breakdown

Fallen angel bonds 'higher quality'



Performance versus credit spread comparison

Fallen Angels have outperformed the broad U.S. high yield market in periods with below average spreads



Key observations

- Fallen angel high yield bonds are part of the overall high yield universe but unique in that they were originally issued with investment grade ratings and later downgraded to non-investment grade, or high yield.
- The unique performance drivers of fallen angel bonds—such as systematically buying oversold bonds, differentiated sector exposure, and higher credit quality—have led to outperformance compared to the broader high yield market, especially in tighter spread environments like the one we're currently experiencing.
- It's crucial to be selective in the high yield space. A prolonged "higher rates for longer" environment could challenge the debt serviceability of lower-quality instruments.

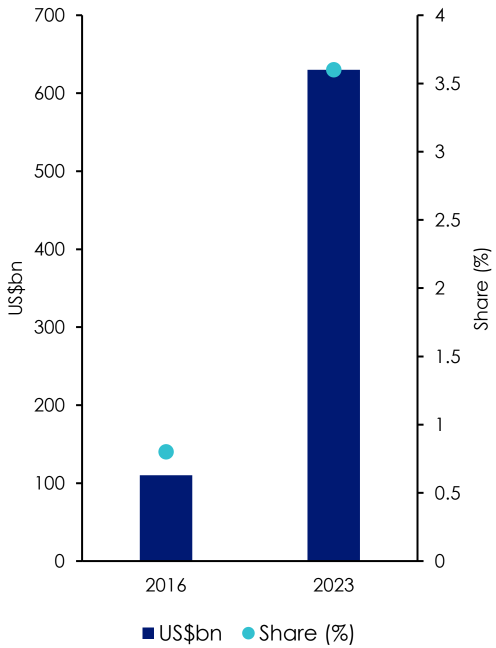
Source: ICE. Past performance is not indicative of future results. See disclaimers and index descriptions at the end of this presentation. Fallen Angel U.S. High Yield by the ICE US Fallen Angel High Yield 10% Constrained Index (H0CF) and Broad U.S. High Yield by ICE BofA High Yield Index (H0A0). Fallen Angel U.S. High Yield index data on and prior to February 28, 2020 reflects that of the ICE BofA US Fallen Angel High Yield Index (H0FA). From February 28, 2020 forward, the Fallen Angel U.S. High Yield index data reflects that of the Fund's underlying index, the ICE US Fallen Angel High Yield 10% Constrained Index (H0CF). Fallen Angel U.S. High Yield index data history which includes periods prior to February 28, 2020 links H0FA and H0CF and is not intended for third party use.

Global listed private credit

Growing institutional adoption. Higher return versus risk profile compared to traditional asset classes.

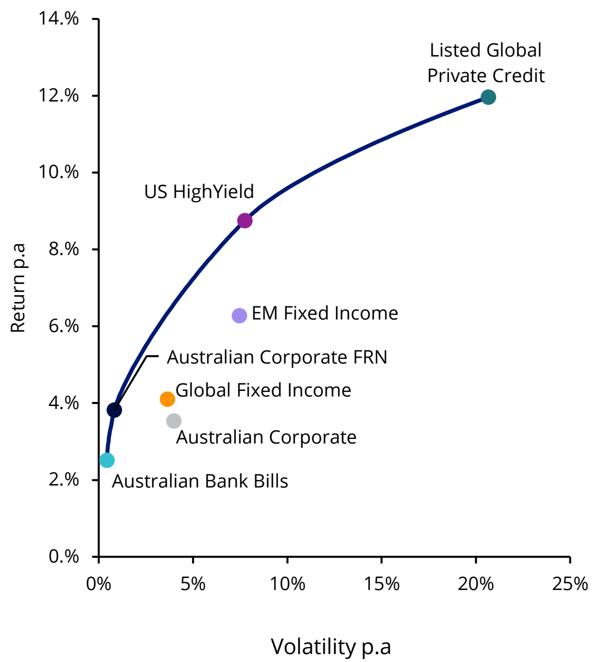
US investment in private credit by pension funds and insurance firms

Six-fold increase over the past 7 years



15 year performance versus volatility

Higher return versus risk profile compared to traditional asset classes



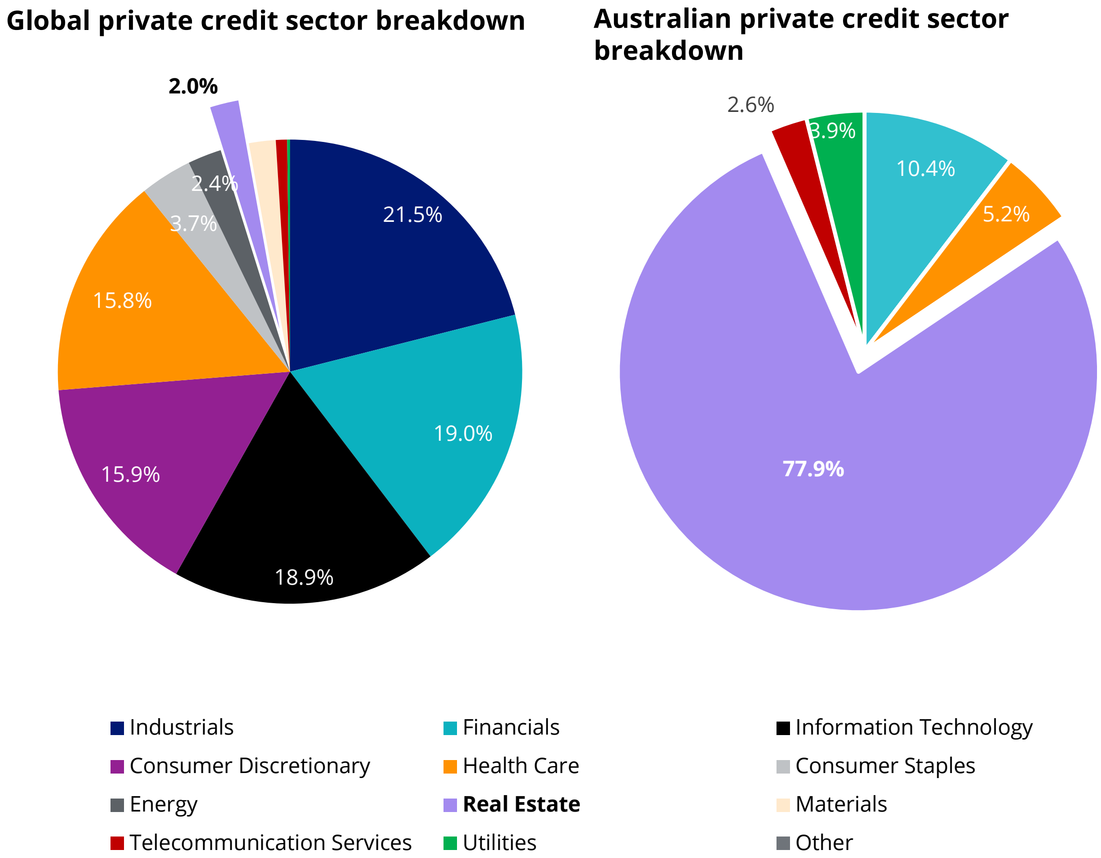
Key observations

- Private credit is gaining prominence among asset owners as a well-established asset class, driven by a surge in demand.
- Private credit AUM held by asset owners has increased six-fold over the past 7 years.
- Investors are attracted by the higher return versus risk profile compared to traditional asset classes, diversification benefits and for potential protection against rising rates as most loans are floating.
- Price discovery and mark-to-market valuations will test investor risk appetite and liquidity constraints.

Source: Bloomberg, IMF. 1 January 2009 to 31 December 2023. returns in Australian dollars. You cannot invest in an index. Past performance is not a reliable indicator of future performance. Indices used: Global Fixed Income – Barclays Global Aggregate Bond Index A$ Hedged; Australian Corporate – Bloomberg AusBond Corporate 0+ Yr Index; Australian Corporate FRN - Bloomberg AusBond Credit FRN 0+ Yr Index; US High Yield – Bloomberg US High Yield (AUD Hedged); Australian Bank Bills – Bloomberg AusBond Index; Australian Hybrids is Solactive Australian Hybrid Securities Index, Listed Global Private Credit – LPX Listed Private Credit Index AUD Hedged, Australian Corporate Bonds – Bloomberg AusBond Credit 0+ Yr Index, Global Corporate Bonds - Bloomberg Global Aggregate Corporate Bond Index (AUD Hedged). Past performance is not indicative of future performance.

Global listed private credit

Global exposure offers superior sector diversification relative to Australian private credit



Key observations

- Global listed private credit has been pivotal in scaling up technology infrastructure and enhancing workflow efficiencies while allowing business owners to retain equity stakes.
- Global listed private credit primarily serves service-based industries.
- Australian private credit funds typically provide concentrated exposure to real estate.
- Insolvencies in the property and construction sector are rising, adding to the risk of loan defaults. ASIC, the Australian corporate regulator reported that 28% of business collapses in 2023 were in the building and construction industry.

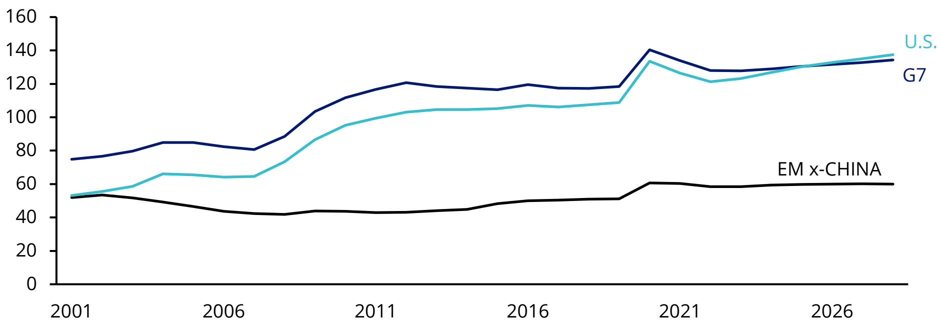
Source: LPX, Metrics.

Emerging market debt

Stronger fundamentals than developed markets

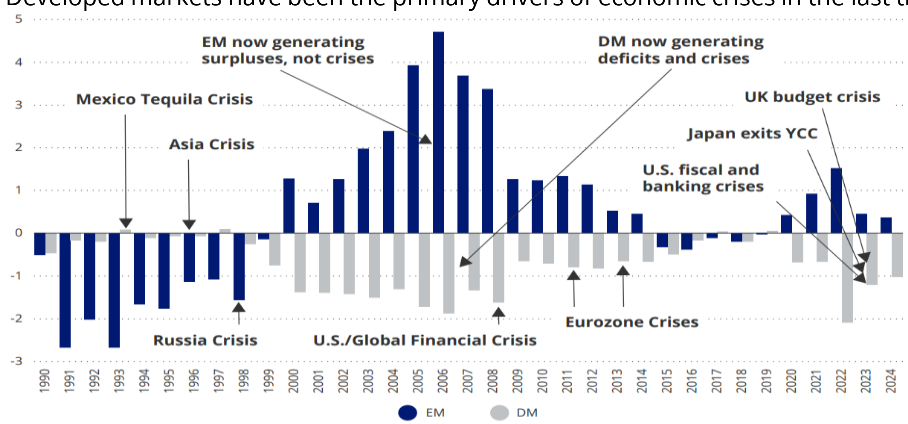
Government debt - % of GDP

Emerging market debt levels superior to developed markets



Current account balances - % of GDP

Developed markets have been the primary drivers of economic crises in the last three decades



Source: Bloomberg, IMF.

Key observations

- Over the past three decades, there has been a notable transition.
- Economies of emerging markets have shifted from deficits to surpluses. Concurrently, economies in developed markets have been accumulating deficits. This has led to a change in the source of economic crises.
- Previously, up to the end of the 20th century, emerging markets were commonly associated with bond crises. However, since 1998, most financial crises have implicated major developed markets.
- Despite this, bond portfolios have not adjusted to acknowledge this shift, which positions emerging market debt as a compelling investment.

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