COOLABAH CAPITAL INVESTMENTS™
THE INTELLECTUAL EDGE: **MAKING EVERY BASIS POINT COUNT**

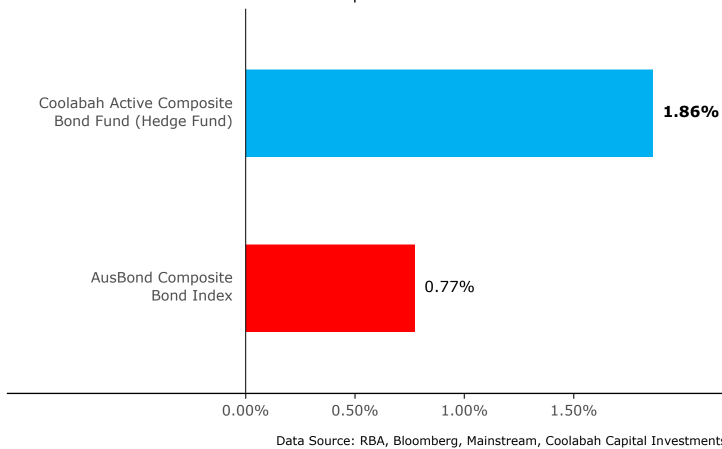
Fund: **Coolabah Active Composite Bond Fund (Hedge Fund)**
Strategy: **Composite Bond**
Return (since Mar. 2017): **2.52% pa gross**
Net return volatility (since Mar. 2017): **4.45% pa**

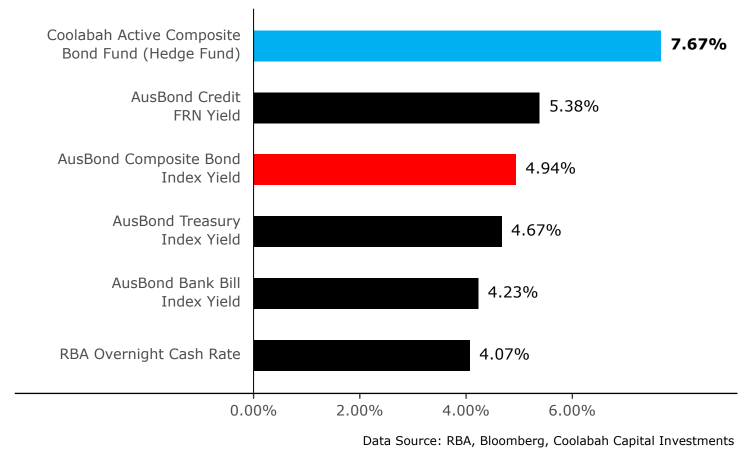
October 2023

Objective: A relative return fixed-income strategy focused on mispricings in government and corporate bond markets. The performance objective for the Coolabah Active Composite Bond Fund (Hedge Fund) is to outperform the Bloomberg AusBond Composite 0+ Yr Index over rolling 12 month periods by 1% - 2%.

Strategy: Coolabah Capital Investments (Retail) (CCIR) adds value via active asset-selection using a range of valuation models with the aim of delivering superior risk-adjusted returns over the Bloomberg AusBond Composite 0+ Yr Index. CCIR actively manages a highly liquid and highly rated portfolio that consists of cash, cash equivalents, government bonds, and investment-grade floating-rate notes. The Manager will add value through its active asset-selection style that harnesses a suite of proprietary top-down and bottom-up quantitative valuation models. CCIR's goal is to generate true valuation alpha by exploiting mispricings.

Period Ending 2023-10-31	Gross Return	Net Return†	AusBond Composite 0+Yr Index	Gross Excess Return‡	Net Excess Return†‡
1 month	-1.66%	-1.69%	-1.85%	0.19%	0.16%
3 months	-1.95%	-2.10%	-2.63%	0.68%	0.53%
6 months	-2.63%	-3.21%	-5.20%	2.57%	1.99%
1 year	**5.22%**	**4.44%**	**-1.18%**	**6.41%**	**5.63%**
3 years pa	-3.15%	-3.70%	-4.61%	1.46%	0.90%
5 years pa	2.02%	1.26%	-0.13%	2.15%	1.39%
Inception pa Mar. 2017	**2.52%**	**1.86%**	**0.77%**	**1.75%**	**1.09%**





† Net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement. ‡ The Excess Return column represents the gross and net return above the Bloomberg AusBond Composite 0+ Yr Index

Disclaimer: Past performance does not assure future returns. Returns are shown gross of all Management and Performance fees unless otherwise stated. All investments carry risks, including that the value of investments may vary, future returns may differ from past returns, and that your capital is not guaranteed.

Net Monthly Returns > AusBond Composite Bond 0+Y Index	68%	Modified Interest Rate Duration	4.91 years
Av. Portfolio Credit Rating	A+	Gearing Permitted?	Yes
Portfolio MSCI ESG Rating	AA	1 Year Av. Gross Portfolio Weight to Cash	0.9%
No. Cash Securities	16	Gross Cash Securities + RBA Repo-Eligible Debt	57.0%
No. Notes and Bonds	146	Net Annual Volatility (since incep.)	4.45%
Av. Interest Rate (Gross Running Yield)	6.31%	**Awards:** FE Alpha Manager 2019: Christopher Joye; **Strategy Ratings:** Recommended (Lonsec); Zenith available to clients	

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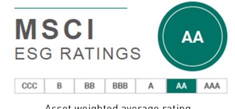
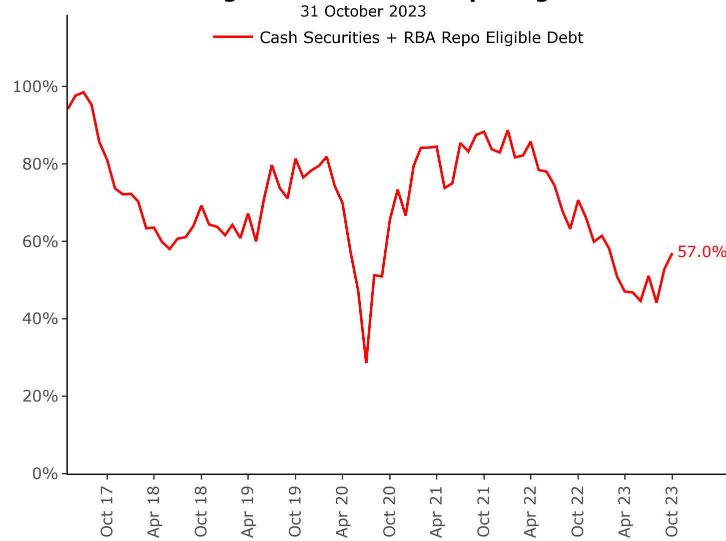
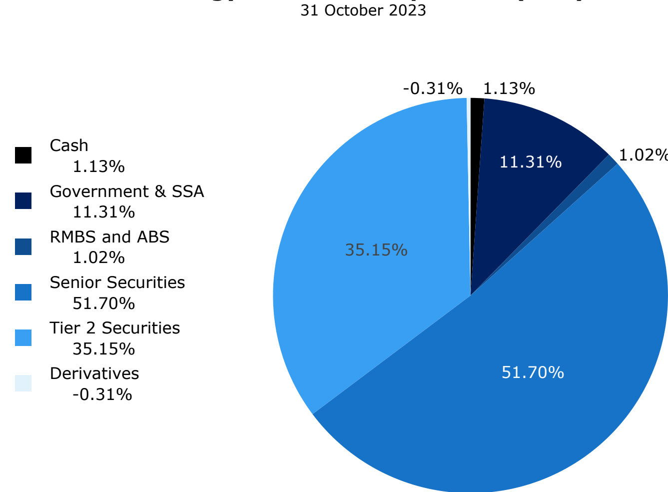




Data Source: Coolabah Capital Investments



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The since inception gross (net) return of 2.52% pa gross is the total annual return earned by the fund since Mar. 2017, including interest income and movements in the price of the bond portfolio after all fund fees (assuming net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement). The net return quoted applies to the Coolabah Active Composite Bond Fund (Hedge Fund), with quarterly distributions reinvested. Each investor's return will vary depending upon their own investment date and any top-ups and withdrawals they make. **The annualised volatility estimate of 4.45% pa** is based on the standard deviation of net daily returns since inception, which are then annualised, attributable to the Coolabah Active Composite Bond Fund (Hedge Fund).

Portfolio Managers — Christopher Joye, Ashley Kabel, Roger Douglas, Dr Nick Campregher (Coolabah Capital Investments)

Asset-Class	Composite Bond	Strategy Inception	07-Mar-2017
APIR Code	ETL2716AU	Ticker	FIXD
Benchmark	Bloomberg AusBond Composite 0+ Yr Index	Unit Pricing	Daily (earnings accrue daily)
Target Return	Composite Bond 0+ Yr Index + 1%-2% pa	Distributions	Half yearly
Target Volatility	Less than 4% pa	Mgt. & Admin Fee	0.30% pa
Investment Manager	Coolabah Capital Investments (Retail)	Perf. Fee	20.5% of outperformance of benchmark after fees

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Recommended Lonsec Research

ALPHA MANAGER 2019 Christopher Joye

SUPERIOR MORE COMPLEX Foresight Analytics

MSCI ESG RATINGS AA
CCC B BB BBB A AA AAA
Asset weighted average rating

Portfolio commentary: The long duration daily liquidity Coolabah Active Composite Bond (Hedge Fund) Fund (FIXD) ended October with an annualised yield to call/maturity of 7.67% pa (assuming current funding costs), a weighted-average credit rating of A+, and a portfolio weighted average MSCI ESG rating of AA. In October, FIXD outperformed the AusBond Composite Bond Index (-1.85%) by 0.19% (0.16% net). Over the previous 12 months, FIXD returned 5.22% pa gross (4.44% pa net), outperforming the AusBond Composite Bond Index (-1.18% pa) by 6.41% pa (5.63% pa net).

Since the inception of FIXD 6.7 years ago in March 2017, it has returned 2.52% pa gross (1.86% pa net), outperforming the AusBond Composite Bond Index (0.77% pa) by 1.75% pa (1.09% pa net). While FIXD's return volatility since inception has been low at around 4.45% pa (measured using daily returns), as a daily liquidity product with assets that are marked-to-market using executable prices, volatility does exist. This contrasts with illiquid credit (eg, loans and high yield bonds) wherein assets that have very high risk can appear to have remarkably low volatility, which is, in fact, just a mirage explained by the inability to properly value these assets using executable prices.

Strategy commentary: October was another absolutely brutal month for equities risk with the S&P500 losing 2.2%, the Eurostoxx 50 shedding 2.7%, and the ASX All Ordinaries Index slumping 3.9%. The Russell 2000 Index in the US is down about 5.6% in 2023 as at 31 October. This was explained by a continued escalation in long-term risk-free interest rates as the US 10-year government bond yield leapt another 36 basis points (bps) from 4.57% to 4.93% in concert with rising risk-aversion as a result of the advent of serious military conflict in the Middle East.

The ascent in long-term US risk-free rates was fueled by the higher-for-longer narrative gripping after the Federal Reserve slashed its projected rate cuts in 2024 in half coupled with an expansion in the quantum of US government bond issuance, which has surprised some participants. The latter is being powered by President Biden running enormous fiscal deficits worth about 6% of US GDP. Interestingly, the increase in discount rates was not universal: German 10-year government bond yields slipped 3bps in October, UK yields rose 7bps, while Australian yields jumped 43bps from 4.49% to 4.92%.

The risk-off tone bled into synthetic credit spreads as the US investment-grade credit default swap (CDS) index, known as CDX IG, climbed 6bps, which was emulated by an identical move in the European IG CDS index, known as Main. In high-yield bond markets, the US CDS index, CDX HY, widened by 36bps. Spreads on its European equivalent, Xover, climbed 22bps.

According to Bloomberg data, overall cash credit spreads in the US and Europe increased from 121bps to 129bps and 153bps to 160bps in October, respectively. Comparatively low beta Australian cash spreads drifted from 152bps to 154bps.

US high-yield spreads, as proxied by B rated bonds, increased aggressively from 419bps to 468bps above US treasury yields, although these remain well-below long-term average spreads around 550bps and the 750bps to 1000bps plus spread range that B rated bonds normally attain during a serious default cycle, like the current one.

The coincidence of widening credit spreads and much higher long-term risk-free rates hurt fixed-rate bond indices. The fixed-rate Bloomberg Global Aggregate Corporate Index lost 1.04% in October. Coolabah's Global Active Credit Fund that is benchmarked against the Global Aggregate Corporate Index outperformed this benchmark by 0.38% in its very first month.

Australia's AusBond Composite Bond Index fell by an even larger 1.85%. Coolabah's Australian long duration strategy, called the Active Composite Bond Fund, outperformed the Composite Bond Index by 0.16% net of fees in October and has beaten the index by 5.6% after fees over the 12 months to 31 October (specifically returning 4.44% net versus the index's 1.18% loss).

As 10-year government bond yields approached 5% in October, long-dated interest rate duration exposures are becoming particularly attractive from an asset-allocation perspective. It may make sense for investors to consider averaging into duration given the elevated level of outright yields and some partial evidence that tight monetary policy in the US is compelling mean-reversion in consumer price pressures.

Strategy commentary cont'd:

What did perform in October was cash and high-grade (ie, highly-rated) floating-rate bonds/notes. Cash rates of 5% or higher in countries like the US, Canada, Britain, and New Zealand would have delivered monthly returns north of 0.4%.

A zero-duration version of the Bloomberg Global Aggregate Corporate Index, which hedges out all interest rate risk exposures, rose by 0.18% in the month compared to the 1.04% loss posted by the long duration (or unhedged) version). In Australia, the AusBond Bank Bill Index returned 0.33% in October. The AusBond Floating-Rate Note (FRN) Index delivered 0.37%.

Coolabah's floating-rate or zero duration strategies performed solidly in October. The lowest volatility solutions that target 1% and 1.5% over the RBA cash rate, called the Smarter Money Fund and the Coolabah Short Term Income Fund, returned 0.40% and 0.41% gross, respectively (around 0.35% net). Over the last 12 months, the Smarter Money Fund and the Short Term Income Fund have returned 7.2% and 7.3% gross, respectively (circa 6.3% to 6.5% net depending on the unit class).

As the financial market prices in a couple of additional rate hikes from the RBA, the annual yield to maturity on these portfolios has climbed. As at 31 October, the annual yield to maturity on the Smarter Money Fund was 5.75% gross while it was 5.89% gross on the Short Term Income Fund. Both strategies have daily liquidity and an average credit rating of A.

Notwithstanding the losses in equities and bonds, the Long Short Credit Fund returned 0.33% gross (0.27% to 0.29% net) in October and has delivered a return of 15.4% to 15.5% net of fees over the last 12 months to 31 October. This was closely followed by the Floating-Rate High Yield Fund, which returned 0.26% gross (0.17% to 0.19% net) in the month and 10.3% to 10.5% net of fees over the past 11 months (it launched in December 2022 and has not yet completed a full year).

The Long Short Credit Fund had an annual yield to maturity of 9.36% gross at the end of October with an average credit rating of A+. The Floating-Rate High Yield Fund had an annual yield to maturity of 9.63% and an average rating of A.

Please note that past performance is no guide to future returns and investors should consult the product PDS to better understand the risks.

The high yields on these strategies supported performance in the face of a widening in credit spreads. In Australia, five-year major bank senior bond spreads appreciated from 92bps to 95bps over the quarterly cash benchmark, known as the bank bill swap rate (BBSW). While there were no new major bank senior bond issues, we did see an AAA-rated RMBS transaction from CBA that priced at 105bps over BBSW.

With three of the four major banks set to report their full-year results in November, we have been expecting a hybrid issue from Westpac and senior bond deals from NAB given each bank's public requirements. Both issues should come with handsome new issue concessions in lieu of how fragile global financial markets are right now.

In the Tier 2 bond market, there were no less than four new deals announced in October from CBA (205bps over BBSW), QBE (255bps over BBSW), Bendigo (260bps over BBSW), and IAG (250bps over BBSW) printing at all-in interest rates of between 6.5% and 7.0%. This sudden spike in supply contributed to five-year major bank Tier 2 bond spreads increasing from about 193bps to 198bps, which taxed performance.

One floating-rate sector that struggled in October was the ASX hybrid market, where spreads on 5-year major bank securities leapt from 253bps to 290bps. This was likely related to expectations of a new deal coming from one of the major banks (since announced to be Westpac) in November.

Coolabah's full capital structure ETF strategy that it runs for BetaShares, known as HBRD, substantially outperformed the Solactive major bank hybrids Index by 0.62% in October as a result of the strategic repositioning of its portfolio away from hybrids and into higher-ranking senior bonds and Tier 2 bonds. Despite HBRD's move up the capital stack, its annual yield to maturity remains a robust 6.53%. At the end of October, HBRD was diversified across 86 hybrids/bonds, and had a 38.2% allocation to hybrids, 49.8% to subordinated bonds, 10.8% to senior bonds, and 1.3% to cash.

Strategy commentary cont'd: One in five borrowers is in trouble

The RBA is a national treasure in terms of the research it consistently produces. This was showcased once again via its influential Financial Stability Review. Media commentators and the RBA celebrated the fact that about 87% of all borrowers have enough income to meet their debt repayments after accounting for essential living expenses (assuming no more increases).

The flip side of this coin is that 13% of all borrowers have negative cash flows (or cannot afford to make their debt repayments after living costs, including private health and school fees). This is up from a mere 3% of borrowers in 2022.

If the RBA were to lift its cash rate to 5.1% in line with peers, it judges that 17-18% of all borrowers would have negative cash flow (technically, there is scope to reduce outlays by relying on public rather than private health/education).

The RBA notes, as we have done, that borrowers do have the benefit of large cash buffers accumulated during the pandemic, which they can draw down on to meet repayments until these excess savings are exhausted.

Our analysis indicates that while the US buffers will disappear within months, much larger Aussie surpluses will not be eroded until late 2024. But while the RBA and media are crowing about how Aussie households and businesses can comfortably wear higher interest rates, which is true, the tails of this distribution are still getting crushed.

Our analysis of the latest monthly insolvency data from ASIC casts this into sharp relief. In August, 817 Aussie businesses went bust in seasonally adjusted terms, the highest since 2015. The key, however, is the direction of the trend line: insolvencies look like they are heading a lot higher.

We are also seeing a structural break in the delinquencies reported on home loans issued by banks as opposed to non-banks. The 30-day arrears rate on bank home loans that have been securitised (sold) has bumped from 0.6% to 0.8% (hedonically adjusted). Yet if we look at prime loans issued by non-banks, the 30-day arrears rate has spiked by 50% from 0.89% to 1.34%.

If one examines sub-prime home loans originated by non-banks, the news is worse with the 30 days arrears rate leaping from 2.5% to almost 4%.

This very much accords with the RBA's research on riskier borrowers. Whereas 13% of Aussie borrowers have negative cash flows net of essential living expenses, this jumps to an incredible 49% of borrowers with high loan-to-income (LTI) ratios and 32% of borrowers with high loan-to-value ratios (LVRs). "These borrowers are much more likely to struggle to meet their essential spending needs," the RBA says.

And for all the talk of the fixed-rate mortgage cliff being a myth, it is presumptuous to make that claim. The RBA advises that most borrowers who took circa 2% fixed-rate loans have yet to roll to the floating rates that will radically increase their repayments: specifically, 55% remain fixed.

Although more than 80% of fixed-rate borrowers have spare savings to cover more than three months of scheduled mortgage repayments, and about two-thirds have savings to cover at least 12 months of repayments, almost one in five fixed-rate borrowers do not.

In the RBA's sanguine words, "there is also a smaller share of fixed-rate borrowers (less than 20%) who will roll off onto higher interest rates with much lower savings buffers, equivalent to less than three months of scheduled mortgage payments".

You can, therefore, spin this two ways: either most borrowers are fine or there are one in five who are screwed. In particular, the RBA assesses that 18% of fixed-rate borrowers will have negative cash-flows once they roll to variable, assuming no more hikes (this number is 7% of borrowers if one uses a narrower definition of essential expenses excluding private health and school fees).

The RBA also expressly warns, as we have done, about the coming high-risk debt default cycle and pain for non-bank lenders that have financed dodgier businesses and households.

Strategy commentary cont'd: "After a period of fewer business failures, bankruptcies have risen in a range of economies, including Australia, Europe and the United States," the RBA says. In fact, US bankruptcy filings are at their loftiest levels since 2010.

"Consistent with rising bankruptcies and tighter credit conditions, default rates have increased for market-based corporate debt, with vulnerabilities more pronounced for lower grade corporations," the RBA continues.

"Lower grade corporate debt is characterised by more variable-rate lending, including for leveraged loans [private debt] in Europe and the United States, and is dominated by sectors exposed to cyclical trends, such as consumer products, real estate, and media and entertainment."

"Default rates on speculative-grade debt have increased to be above pre-pandemic levels in Europe and the United States, and default rates are higher for variable-rate borrowers." Beyond spiking defaults, recovery rates on senior secured private loans in the US are at their lowest levels on record as a result of lenders financing businesses with over-inflated valuations.

The RBA extended its warnings to specifically focus on Aussie non-bank lenders, declaring that "the outlook for non-banks' housing loan quality is more challenging than in recent years".

"In an effort to rebuild margins and lending volumes, liaison discussions indicate that some non-bank lenders are relaxing serviceability requirements and targeting higher risk borrower segments, such as those with less documentation about their finances," the RBA reveals.

"At the same time, some non-banks have found it difficult to retain credit-worthy borrowers who have sought to refinance their loans on highly competitive terms with banks," it says.

"A weakening in lending standards and overall loan quality could lead to more risk concentrating in a part of the financial system where regulators have less oversight. Housing loan arrears for non-banks have risen more than for banks (to levels recorded just before the pandemic), partly because they lend to borrowers who are more sensitive to economic conditions, such as the self-employed."

It is prudent to remain liquid and capitalise on high risk-free rates right now.

A likely "material upward revision" to the RBA's inflation outlook

The RBA's big forecast miss on underlying inflation in Q3 risks the slower return of inflation to target that the RBA board warned against.

The latest inflation numbers in Australia came in higher than the RBA had expected, with annual underlying inflation of 5.2% exceeding the RBA's August forecast of about 4.8%, suggesting that the RBA should raise rates in November.

Comparing this 0.4pp forecast miss with history, it represents the equal third-largest error since the RBA started forecasting underlying inflation in the early 1990s (there are ten times the error has been this large over this time).

The current-quarter forecast miss matters because it is positively correlated with forecast revisions to the RBA's inflation outlook in the subsequent Statement on Monetary Policy.

Based on the relationship between the current-quarter forecast miss and the RBA's inflation outlook over the period from 2010 to 2023, the 0.4pp forecast error in Q3 would ordinarily see the RBA raise both its year-ahead and year-and-a-half-ahead forecasts for underlying inflation by about 0.2pp.

This raises the possibility of a "material upward revision" to the outlook, in that - pending a further rate hike - it could see the RBA revise its forecast profile for underlying inflation in 2025 from 2.8-2.9% to 3.0-3.1% in the November Statement on Monetary Policy.

Strategy commentary cont'd: If that happened, it would represent the slower return to the inflation target that the board warned against in the minutes of the October monetary policy meeting.

Strong US wages growth continues

Ahead of the Fed's latest policy meeting, where it kept the funds rate steady at a range of 5.25-5.5%, US wages growth remained strong in Q3.

The Fed's preferred measure of wages - namely, the private-sector employment cost index, excluding commissions – rose by 1.1% in Q3 on CCI's seasonal adjustment, following a 1.1% rise in Q1 and a 1.2% rise in Q2.

This meant that annualised trend wages growth was steady at 4.7% in the quarter, which, while down from last year's peak of 5.8%, is the fastest growth since 2000.

Figure 1: US wages growth remains strong

Note: Seasonally adjusted and detrended by CCI.
Source: FRB of St Louis, Coolabah Capital Investments

US wages growth remains strong

Markets are less sure the Fed and RBA will hit their inflation targets

Market measures of expected inflation have recently picked up in the US and Australia, which is unusual this late in the cycle. The increases could prove temporary if economies soon roll over, but suggest that markets are less sure that the Fed and RBA will successfully contain inflation.

The sharp rise in world bond yields over the past couple of years has been driven by higher real yields, but there has recently been an unusual pick-up in market measures of expected inflation.

In the US, expected inflation – as represented by the 5-year/5-year forward rate – is now at about 2.5% based on both Federal Reserve DKW model estimates that adjust for TIPS liquidity and inflation risk premia and inflation swaps data. [1]

It is unusual for expected inflation pick up this late in a rate hike cycle and the rise may prove temporary if the economy finally rolls over and/or if higher expected inflation partly reflects the risk of a broader conflict in the Middle East.

Nevertheless, this is the highest level of expected inflation in several years and suggests that the market is less certain that the Fed's 5.25-5.5% funds rate will successfully return inflation to the 2% target over the medium term.

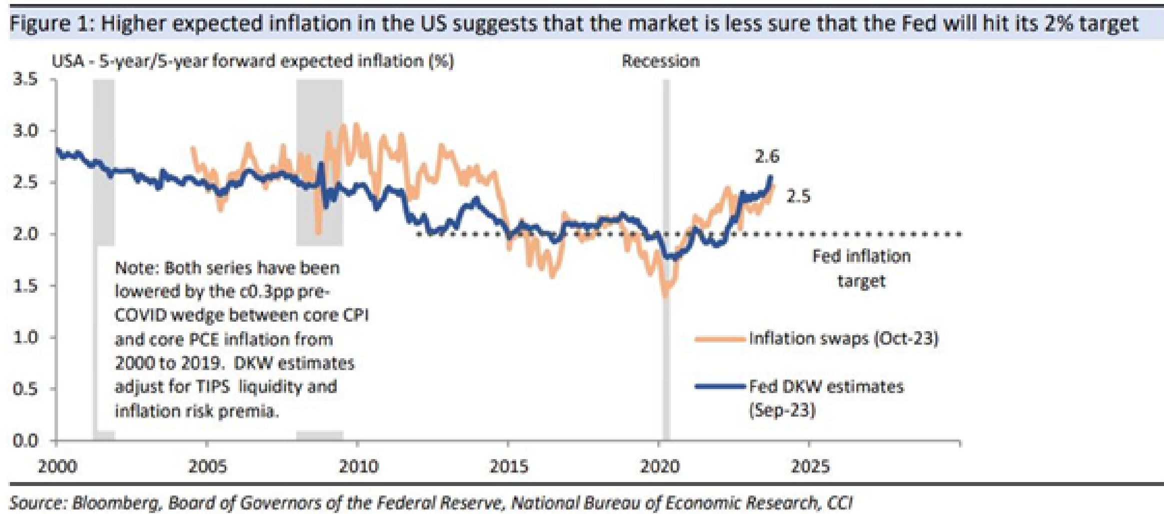
In Australia, there are no equivalent market measures that adjust for inflation-indexed bond liquidity and inflation risk premia, but the expected inflation rate derived from inflation swaps data has also picked up recently to almost 3%, which is the highest level in several years.

Strategy commentary cont'd: This 5-year/5-year forward measure of expected inflation is still within the RBA’s 2-3% inflation target band, but its recent increase suggests that the market is less sure that the current RBA cash rate of 4.1%, together with an expected rate hike, will see the bank hit the 2.5% midpoint of the target band.

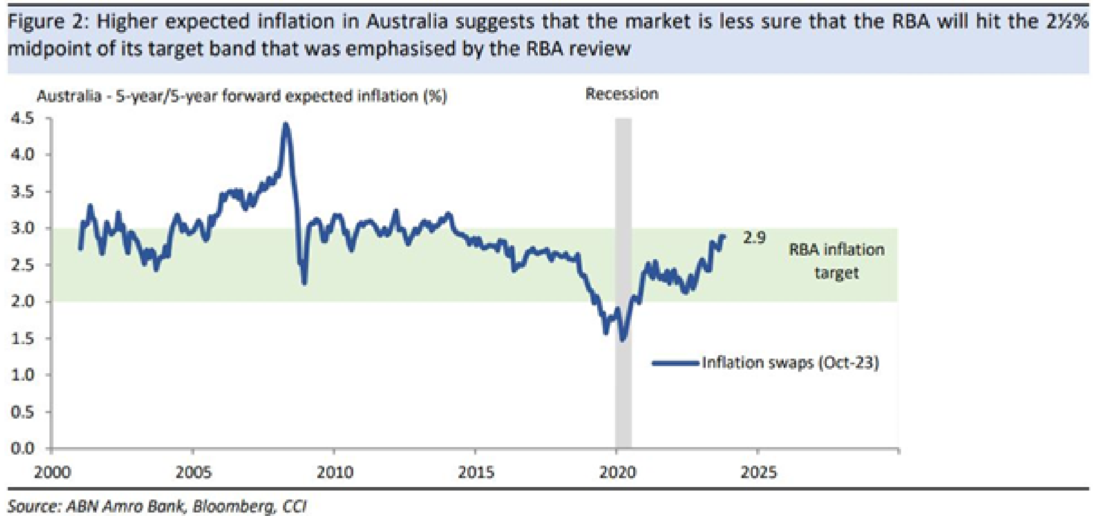
While the RBA still officially targets a 2-3% range for inflation, the yet-to-be-finalised Statement on the Conduct of Monetary Policy – which is the formal agreement on the operation of monetary policy between the treasurer and the RBA board – could emphasise the importance of the 2.5% midpoint given that the recent RBA review explicitly recommended that policy-makers "should aim for the [2.5%] midpoint of the inflation target in order to maximise the chance that the target is met and best anchor inflation expectations”.

Note:

[1] These estimates have been adjusted for the average c0.3pp pre-COVID wedge between CPI inflation, which matters for market pricing of inflation compensation, and PCE inflation, which is targeted by the Federal Reserve.



The market is less sure that the Fed will hit its 2% target over the medium term



The market is less sure that the RBA will hit the 2.5% midpoint of its inflation target

The US Sahm rule recession indicator edges up

Strategy commentary cont'd: *The US unemployment rate has increased to almost 4%, which has seen the Sahm rule – which is a shorthand coincident measure of whether the US is in recession – start to edge up.*

The latest US payrolls report was a little weaker than the market had expected, with the number of payrolls jobs increasing by 0.1% in October, the unemployment rate edging up to 3.9%, and trend growth in average hourly earnings slowing further.

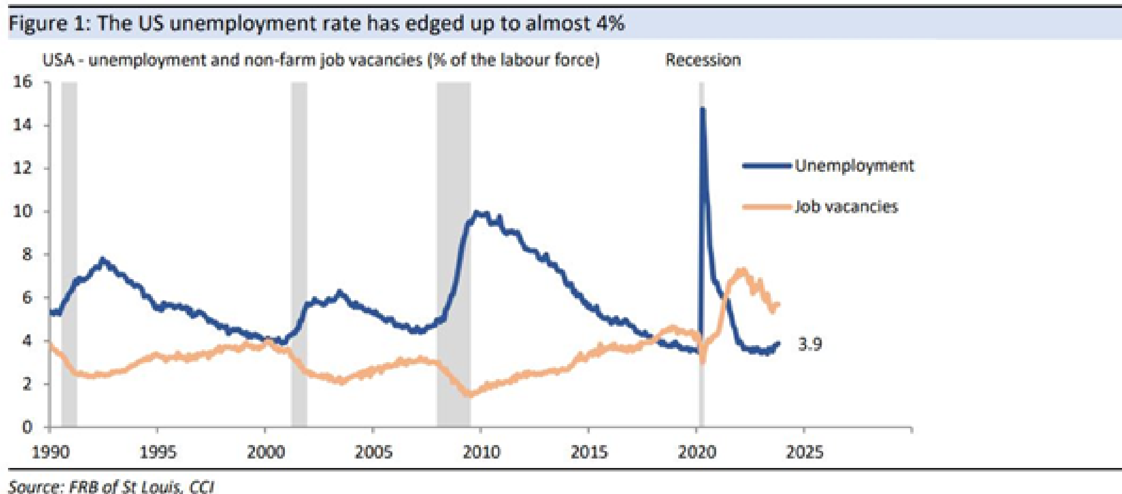
The unemployment rate is now up 0.5pp from its recent multi-decade low of 3.4%, with the Sahm rule – which uses the change in the average unemployment rate as a shorthand coincident measure of whether the US economy is in recession – starting to edge up.

The Sahm rule is that the US has been in recession when the three-month moving average of the unemployment rate rises by 0.5pp or more relative to its low during the previous 12 months.

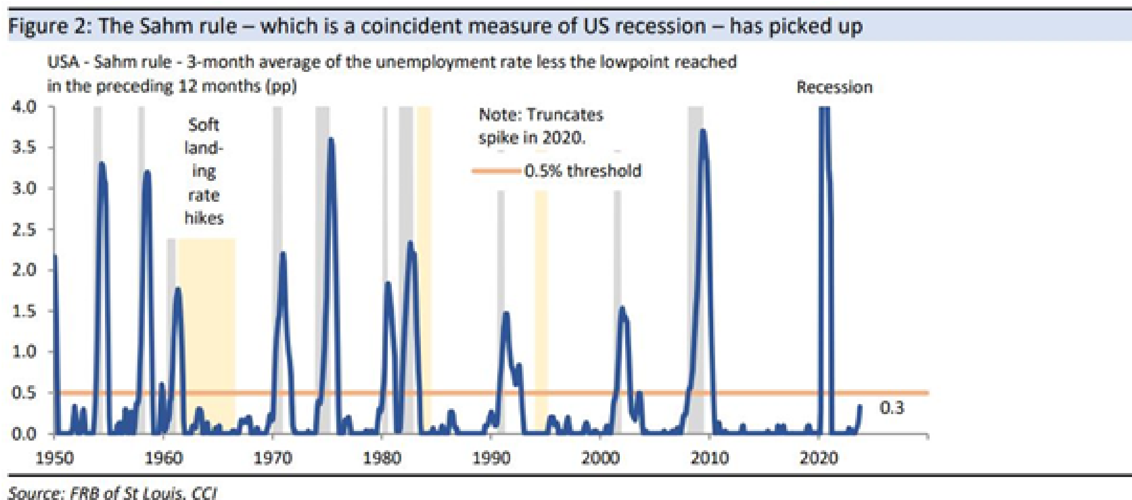
The rule's value picked up to 0.3pp in October, still well short of the 0.5pp threshold, where Sahm has noted, "[the rule] is an indicator, not a forecast, but, clearly, rising unemployment is not a good sign [and] you don't need a rule for that", cautioning that, "[the rule] is an empirical reality, not a law of nature".

The rise in unemployment may seem surprising given that the annualised trend growth in payrolls is about 1.5%, but surveyed employment – which is extremely volatile – is flat in trend terms, where the latter is used to construct the unemployment rate.

Meanwhile, annualised trend growth in private-sector average hourly earnings slowed to 3.5%, similar to pre-pandemic peaks, contrasting with trend growth of 4.75% in the employment cost index ex-commissions, which is the Fed's preferred measure of wages.



The US unemployment rate has edged up to almost 4%



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Recommended Lonsec Research
ALPHA MANAGER 2019 Christopher Joye
SUPERIOR MORE COMPLEX Foresight Analytics
MSCI ESG RATINGS AA
CCC B BB BBB A AA AAA
Asset weighted average rating

Strategy commentary cont'd:

The Sahm rule – which is a coincident measure of US recession – has picked up

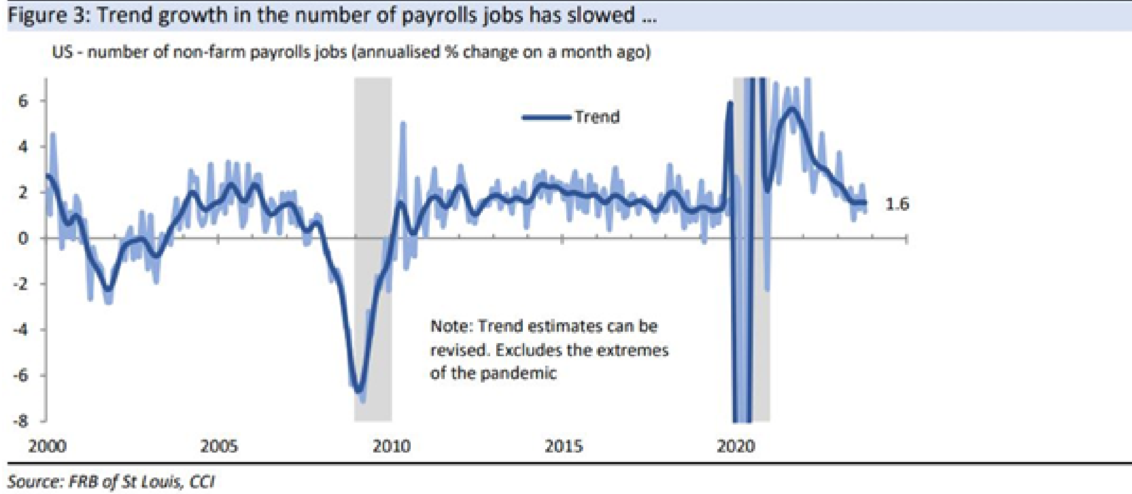


Figure 3: Trend growth in the number of payrolls jobs has slowed ...

Source: FRB of St Louis, CCI

Trend growth in the number of payroll jobs has slowed ...

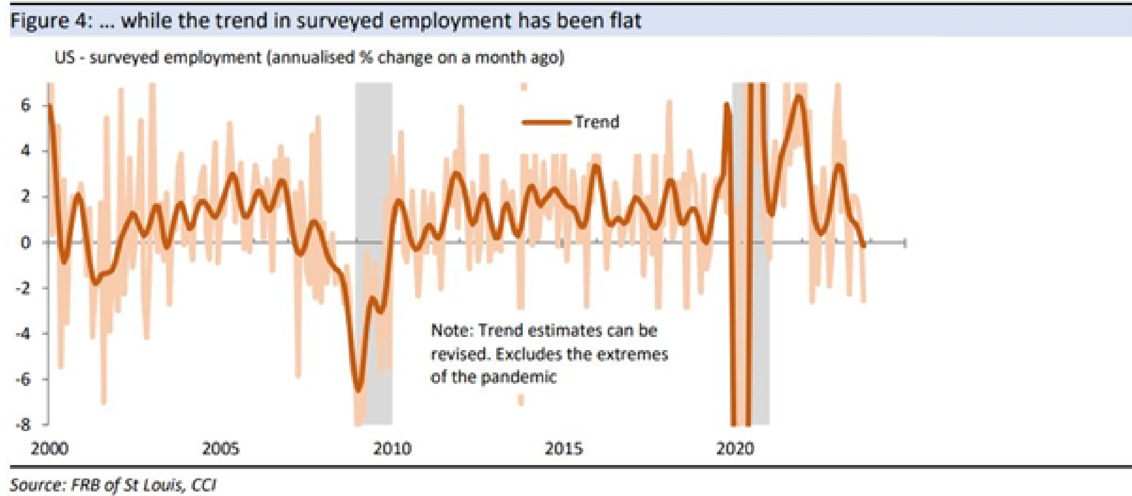


Figure 4: ... while the trend in surveyed employment has been flat

Source: FRB of St Louis, CCI

... while the trend in surveyed employment has been flat

Strategy commentary cont'd:

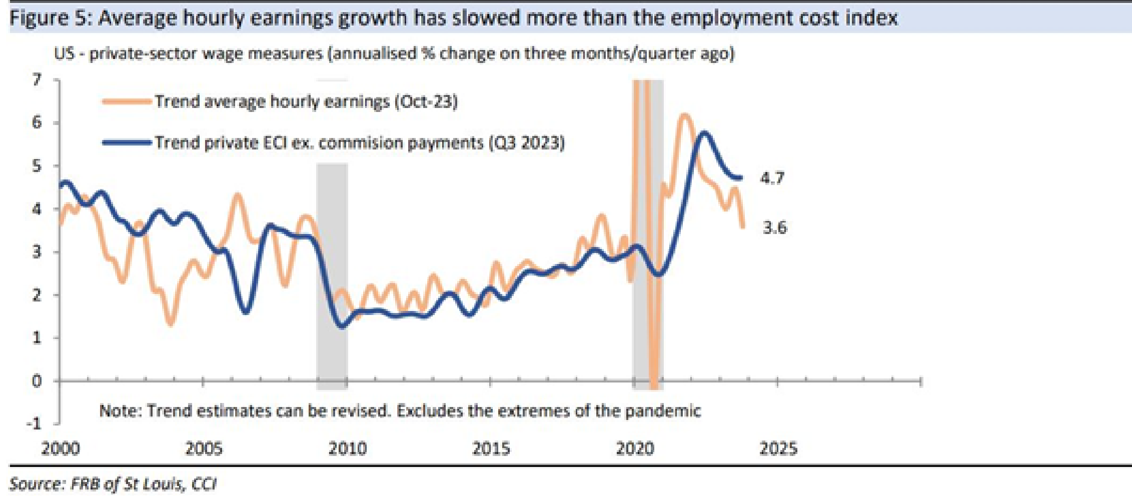


Figure 5: Average hourly earnings growth has slowed more than the employment cost index

Source: FRB of St Louis, CCI

Average hourly earnings are growing more slowly than the employment cost index

A broad recovery in world house price

Ahead of an expected increase in unemployment, the broad recovery in world house prices has continued.

US house prices have now reached a new all-time high, up 1.5% from last year's peak.

Australian prices are back at the record high reached last year.

Canada will likely match its record high in the next month or so.

New Zealand prices continue to recover, but are still well down from their peak.

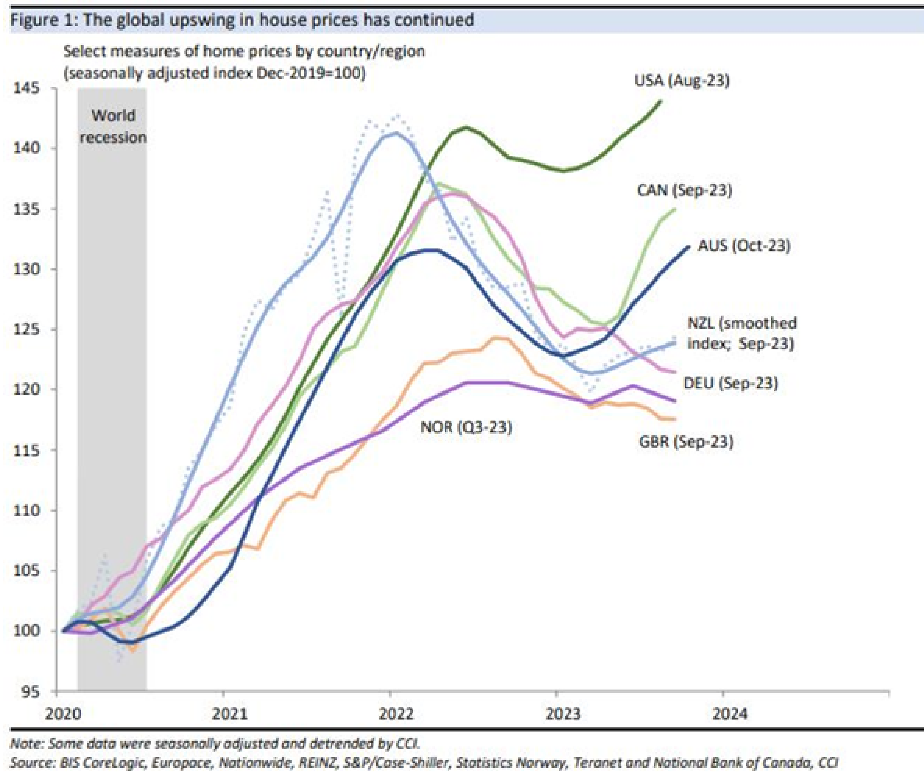
Norwegian prices, which were near their all-time high, took a step back in Q3.

Meanwhile, UK and German prices continue to slowly drift lower.

This broad rebound – which has occurred against the backdrop of the lowest unemployment rates in decades – suggests that high interest rates are not constraining all borrowers.

This raises the question of whether some households believe interest rate cuts are not far away and/or, more importantly, if monetary policy is not sufficiently tight.

Strategy commentary cont'd:



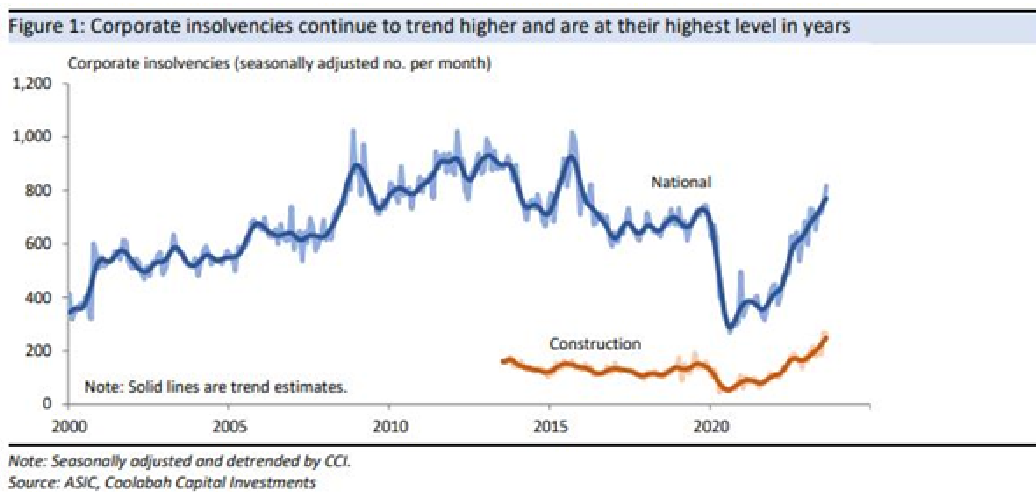
There is a broad recovery in global house prices

Corporate insolvencies head higher

Contrasting with the relative stability in the unemployment rate to date, national corporate insolvencies continue to trend higher, reaching their highest level since 2015 in August.

By industry, construction insolvencies remain the stand-out, where builders have been squeezed by fixed-price contracts on existing projects and reduced demand for new work.

Relatively high interest rates on corporate loans – about 5.5% on average for large businesses and 6.5-7.25% for small- and medium-sized companies – and weak economic growth should see insolvencies trend higher next year.



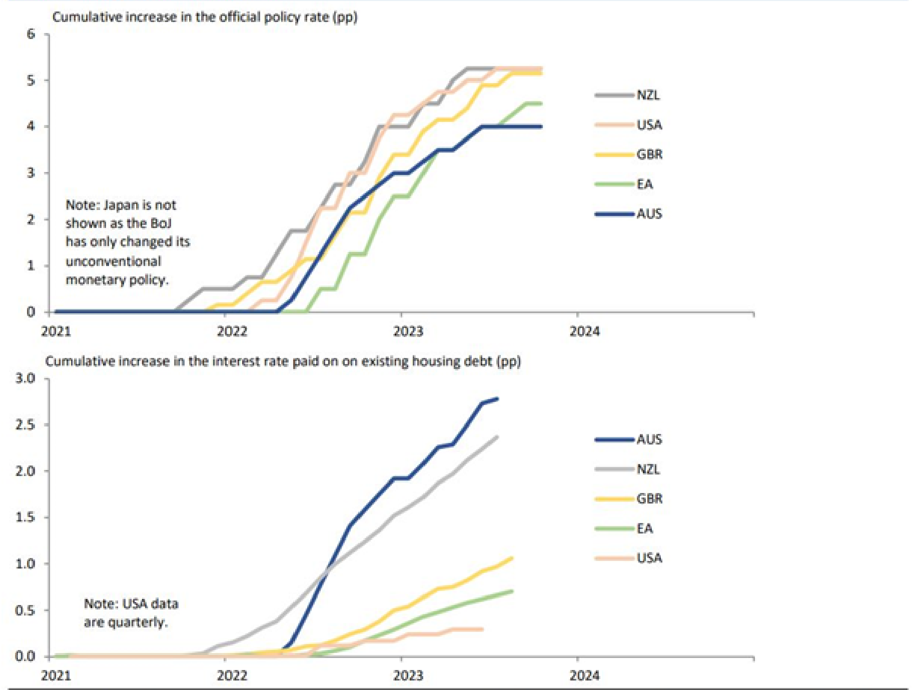
Corporate insolvencies are at their highest level in years

Strategy commentary cont'd: Cash flows and the effectiveness of monetary policy

Despite the greater importance of household cash flows locally, the estimated effect of higher interest rates on inflation is the same in Australia as most other countries. Inflation is not very sensitive to higher interest rates, which suggests that central banks think recent high inflation mostly reflects temporary supply factors.

Many analysts have pointed out that mortgage rates have increased by more to date in Australia than in other advanced economies, even though the RBA has raised the policy rate by less than nearly all of its peers.

Figure 1: The RBA has raised the cash rate by less than most other countries, but, to date, Australia's mortgage rate has increased by more than its peers



Source: Bank of England, Bank for International Settlements, Bureau of Economic Analysis, Federal Reserve Bank of St Louis, Reserve Bank of Australia, Reserve Bank of New Zealand, Coolabah Capital Investments

The RBA has hiked by less than most other countries, but, to date, Australia's mortgage rate has increased by more than its peers

However, the resulting squeeze on household cash flows is not new news as it reflects the combined effect of higher household indebtedness and greater use of variable-rate mortgages in Australia, such that the debt servicing ratio of Australian households is higher and more variable compared with other advanced economies.

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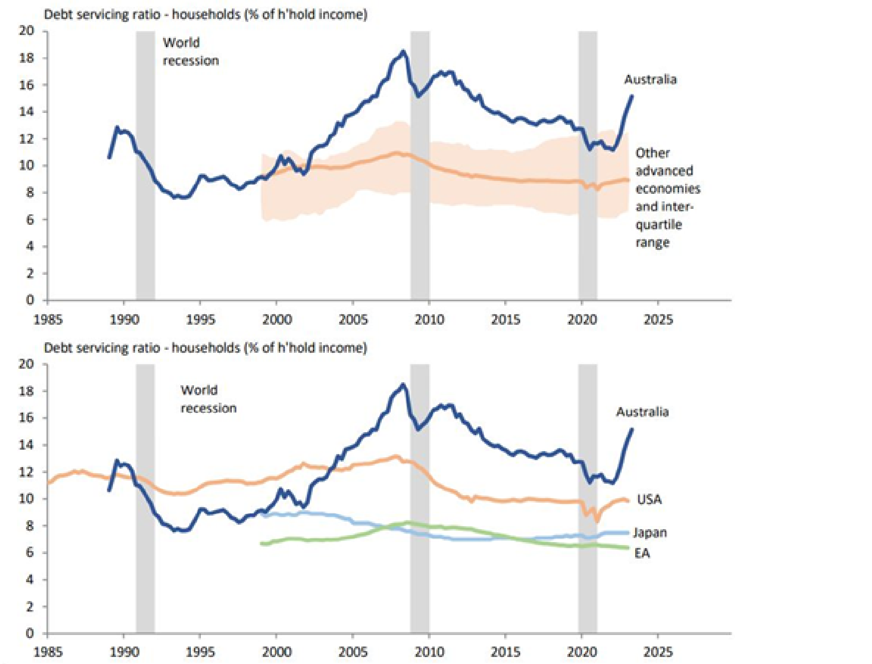
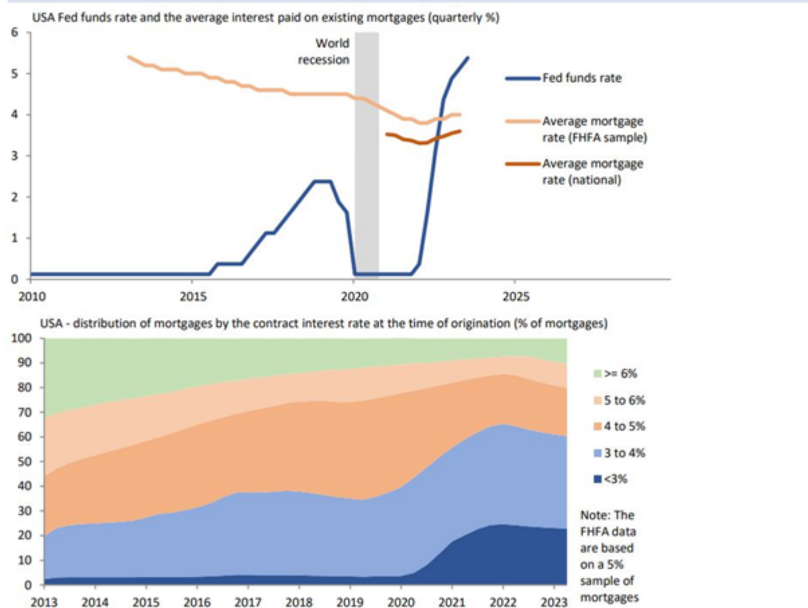
Strategy commentary cont'd:



The debt servicing ratio for Australian households is higher and more variable than most other countries

For example, the US household debt servicing ratio is much smoother in comparison and is yet to react much to recent Fed rate rises given most existing borrowers have locked in much lower long-term mortgage rates.



The US household debt servicing ratio is relatively smooth because most borrowers have locked in low mortgage rates

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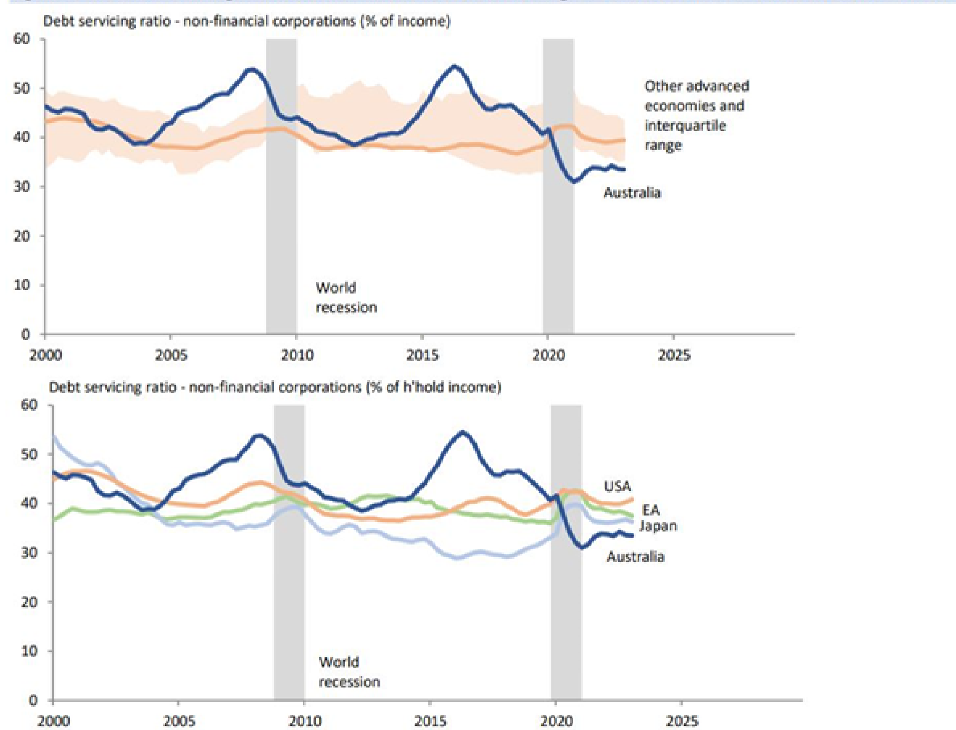
Strategy commentary cont'd: The story for the cash flow of non-financial corporations is similar in that the corporate debt servicing ratio is generally higher and more variable in Australia than in most other advanced economies, although the difference is less marked than for the household debt servicing ratio and the local corporate debt servicing ratio hasn't picked up yet given the importance of cashed-up mining companies.

Figure 4: The debt servicing ratio for Australian businesses is also higher and more variable than most other countries



Note: The other advanced economies debt servicing ratio was PPP weighted by CCI.
Source: Bank for International Settlements, Federal Reserve Bank of St Louis, International Monetary Fund, Coolabah Capital Investments

The debt servicing ratio for Australian businesses is also higher and more variable than most other countries

The greater importance of the household cash flow channel of monetary policy in Australia has led many analysts to believe that higher interest rates are more effective in Australia than in other countries.

However, this does not appear to be the case, in that central bank estimates of the peak effect of higher interest rates on the ultimate objective of inflation – calculated using both macroeconometric and DSGE models – is the same in Australia, the euro area and the US.

This suggests that the combined effect of all the different channels of monetary policy – i.e., household and corporate cash flows, the exchange rate, asset prices, expectations, etc – on inflation is both similar between Australia and other countries and fairly small.

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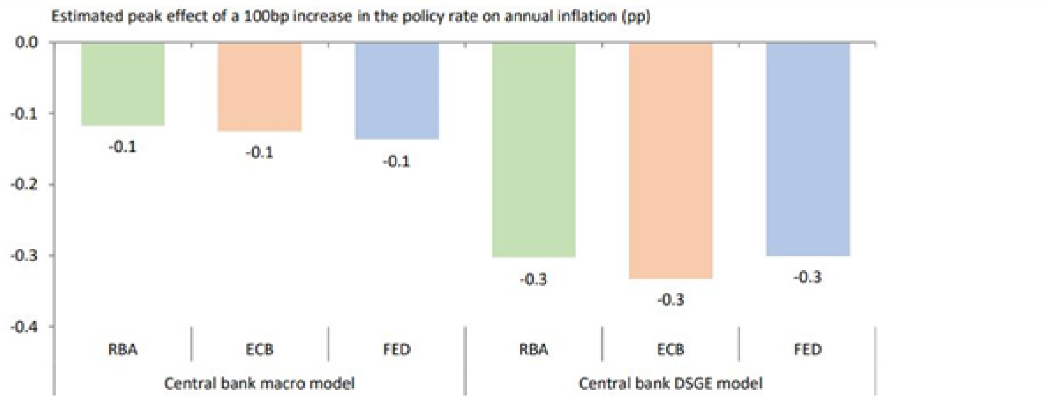
Strategy commentary cont'd:

Figure 5: Despite the greater importance of household cash flows locally, higher interest rates have the same estimated peak effect on inflation in Australia as most other countries



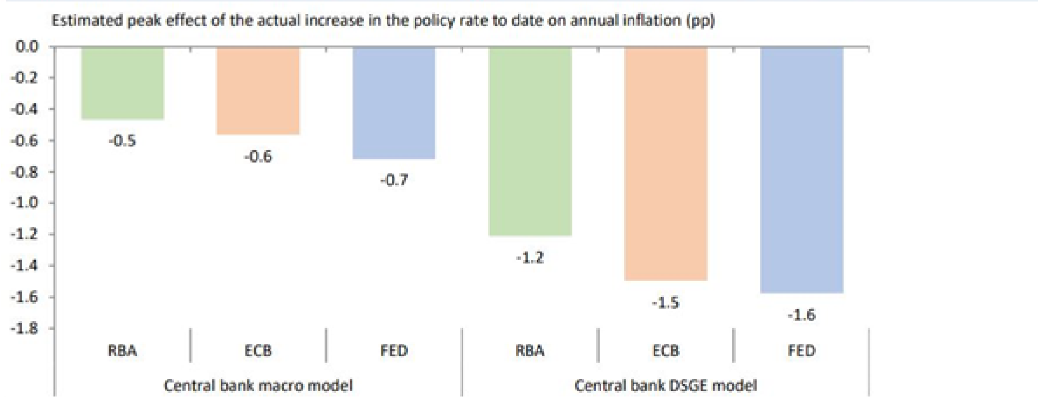
Source: Board of Governors of the Federal Reserve System, European Central Bank, Federal Reserve Bank of New York, Reserve Bank of Australia, Coolabah Capital Investments

Despite the greater importance of household cash flows locally, higher interest rates have the same estimated peak effect on inflation in Australia as most other countries

Using the central bank model estimates of the peak effect of higher policy rates on inflation, Australia has hiked by less than both the ECB and the Fed, such the RBA's likely role in bringing inflation down is much less than what a narrow focus on the household cash flow channel would suggest.

Unless inflation has suddenly become more responsive to higher interest rates, the estimates also indicate that central banks are implicitly assuming that most of the recent surge in inflation reflects temporary supply factors that are now being unwound, with much less of a role for the demand-driven inflation that is sensitive to high interest rates.

Figure 6: Central banks are implicitly assuming that most of the reduction in inflation will reflect the unwinding of temporary supply shocks rather than demand-driven price increases that are sensitive to interest rates



Source: Board of Governors of the Federal Reserve System, European Central Bank, Federal Reserve Bank of New York, Reserve Bank of Australia, Coolabah Capital Investments

Central banks implicitly assume that most of the reduction in inflation will reflect the unwinding of temporary supply shocks rather than demand-driven price increases that are sensitive to interest rates

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