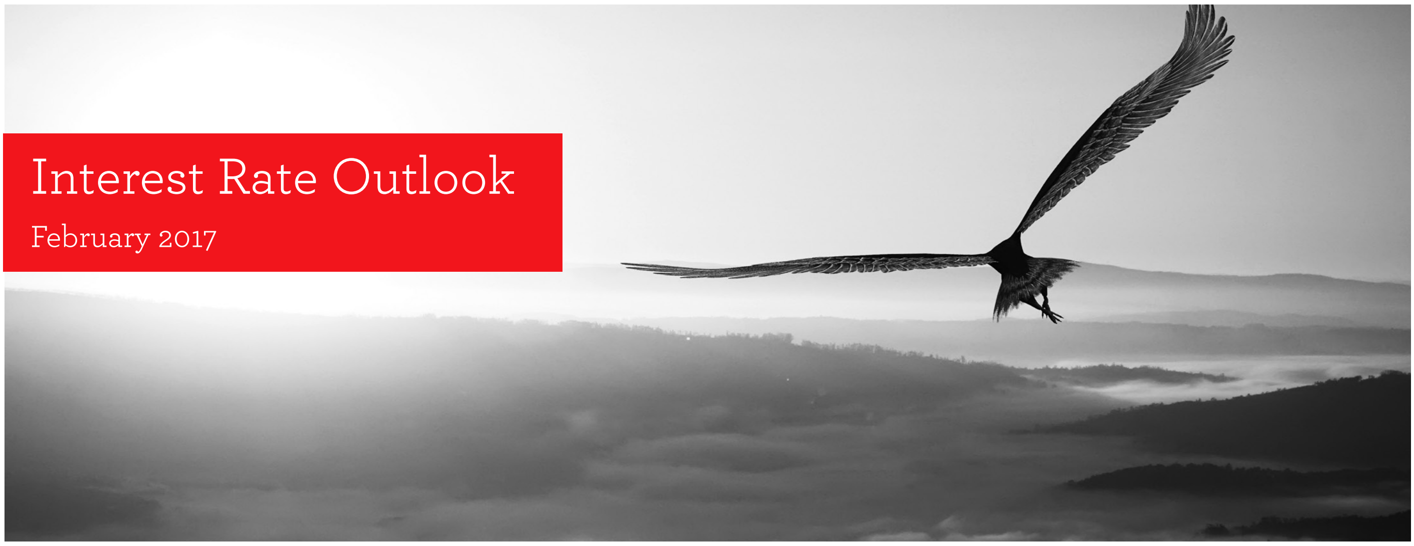
Stamford Capital
AUSTRALIA



Interest Rate Outlook

February 2017

Interesting, the adjective is defined as arousing curiosity or interest; holding or catching the attention, with synonyms of absorbing, engrossing, fascinating, riveting, compelling, spellbinding, etc.

Whilst some of the synonyms may be a little far stretched, the past year could certainly be assessed as interesting to say the least. The questions now is ‘has the landscape changed and what does the future hold’. None of us can predict the future with 100% accuracy all of the time and the landscape has changed.

So, let’s review a couple of the surprises of the past year, 2016, and try and formulate an opinion as to how this projects forward:-

Leicester City won EPL
Cronulla Sharks won NRL GF
Western Bulldogs won AFL premiership
Brexit won over remain
And… Donald Trump won the US Presidency.

Interesting, surprising, may be even astounding.
In September of last year, we undertook an analysis of the A$ yield curve and identified that yield curve between 1 year and 30 years had a spread of just 80 basis points. Clearly, there was no pricing for risk across longer tenors. The spread between the two tenors moved to over 180 bpts in late December and has abated to around 150 bpts presently.
Our view over many years has always been to assess and implement risk management strategies when the market is benign, complacent and low volatility. Why? Generally, the risk premiums and cost of carry is lower, it is easier to set hedging strategies and usually with lower volumes, bank pricing tends to be a little sharper.

We did send out our strategy paper to our existing clients highlighting this and a number of them were able to take advantage of a flat yield curve and extend hedges or initiate new ones. The chart following was the yield curve in September, compared to the curve in December and February 2017 (current).

Yield Comparison Curves Sept/ Dec/Feb

	9/9/2016	12/16/2016	2/2/2017
1Y	1.68%	1.82%	1.79%
2Y	1.66%	1.96%	1.93%
3Y	1.68%	2.15%	2.06%
4Y	1.89%	2.51%	2.43%
5Y	1.92%	2.65%	2.56%
6Y	1.97%	2.77%	2.67%
7Y	2.01%	2.88%	2.77%
8Y	2.06%	2.97%	2.86%
9Y	2.10%	3.05%	2.93%
10Y	2.14%	3.12%	2.99%
12Y	2.22%	3.24%	3.11%
15Y	2.32%	3.36%	3.23%
20Y	2.43%	3.47%	3.36%
25Y	2.49%	3.51%	3.41%
30Y	2.51%	3.51%	3.42%

Interesting to note that the 3 year swap had moved up in yield around 50 bpts which is why hedges are put in place. Clearly, with the benefit of hindsight this can be reviewed, but as the official cash rate is closer to zero now than it ever has been, the probability of further interest rate reductions and subsequent flattening of what was a flat curve reduces.

Our observations are as such:-

- Bank credit is more expensive than it has been due regulatory and cost of capital requirements.
- Bank credit is more difficult to access than previously
- There is a burgeoning growth of non traditional funding channels both on and offshore.
- The yield curve has steepened in line with global yields and will add cost to term debt as a result.
- Banks have independently raised variable mortgage rates without the RBA adjusting policy.
- Oil price has increased which has added pressure at the retail end of fuel pricing.
- Inflation is below the RBA target range.
- Wage inflation is low or non existent.
- Employment data still appears strong, but weighted to growth of part time employment and less hours worked.
- The US new administration are of an unknown quantity and.
- All in all, at this point, we think there has been an effective subtle tightening of monetary policy without the RBA having to officially change anything.

We note that CS had forecast three interest rate cuts in Australia in 2017. Whilst we don't necessarily subscribe to that view, our view is that the current steepening of yields has been overdue (possibly overdone) and there will be a further correction to reduce some of this premium.

Our view is that the RBA are most unlikely to raise official cash rates for at least another year or so with recent inflation data release below trend. Should data be weaker than expected and inflation low again after the first quarter, the RBA may act and reduce rates by another .25bpts. If this were to occur, our forecast timing would be in April or May.

Global bond yields have seen their lows in this cycle and as US yields have risen, Australian yields have been drawn with them.

All in all, we see this year as interesting.

Regards,

Russell Maisner

AUTHORS DISCLAIMER: The person named as the writer of this report hereby certifies that the views expressed in the research report accurately reflect their personal views about the subject securities and issuers and other subject matters discussed. The above does not reflect financial advice nor purport advice and is a view expressed by the writer. The writer does not receive any commissions direct or indirect from any financial institution.