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

Why Cash & Bonds Are Suddenly Sexy in a Rising Interest Rate Climate

FE Alpha Manager:
Coolabah Capital
CCI was selected by researcher FE fundinfo in its Inaugural 2019 Top 11 Australian "Alpha Managers"

August 2022
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MSCI ESG RATINGS
A

CCC	B	BB	BBB	A	AA	AAA

Asset weighted average rating

Please Read Carefully

ALPHA MANAGER 2019
Christopher Joye

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Big Regime Changes: Cash is King

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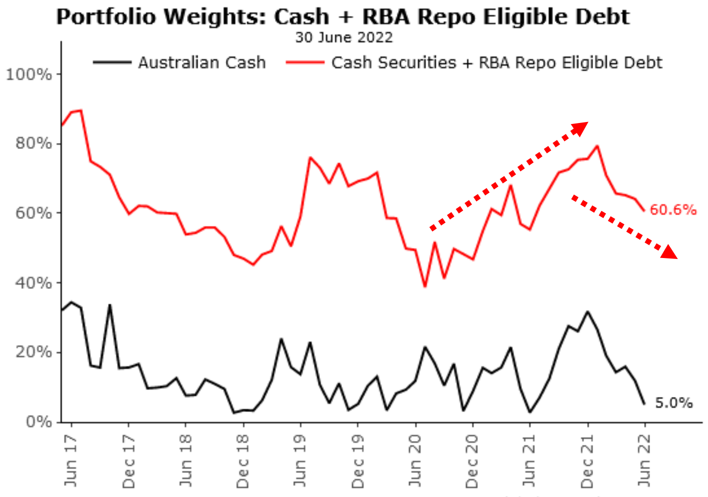
Christopher Joye

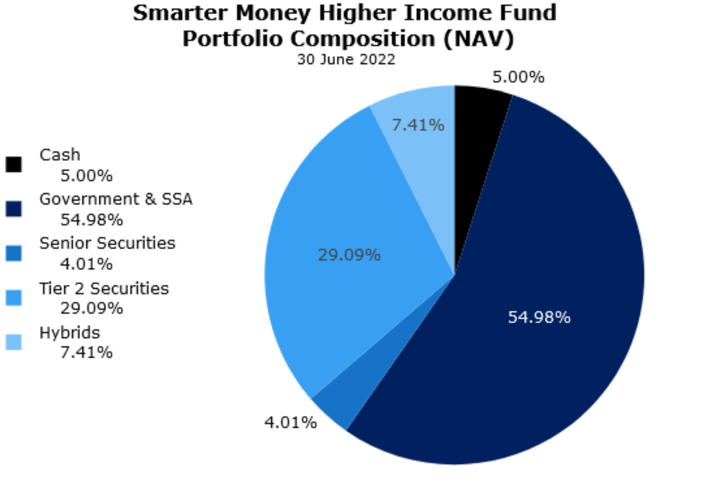
- **RBA cash rate likely going to 2.5% to 3.0%**
  - Market pricing in 3.9% peak RBA cash rate
- **Australia’s 10-year Commonwealth government bond yield is now 3.6% pa (vs 1% in Dec’ 21)**
  - Australia’s 3-year Commonwealth government bond yield is 3.2% pa
- **12 month term deposit rates as high as 4.1% pa**
  - One year ago they were only paying circa 0.5% pa
  - How do you rationalise net residential property yields of 3% - esp. while prices plunging?
- **5-year major bank fixed-rate Tier 2 bonds paying as much as 6.4% pa**
  - Compares to Aussie equities dividend yield of 6.1% including franking
  - 5-year major bank floating-rate Tier 2 bonds paying 5.1% pa
  - One year ago they were only paying 1.3% pa
- **Since the GFC, cash and bonds have paid terrible interest rates**
  - Due to concerns about low inflation/deflation
- **But in a high inflation environment, your single best hedge has always been floating-rate cash**
  - If you have an inflation-targeting central bank, which we have…
  - In FY22, floating-rate listed hybrids were best performing asset-classes (up 0.14% including franking)
  - You can now get 4.1% pa risk-free in cash
  - Cash is king and bonds are sexy again…

Bonds are sexy again

CCI was Uber Negative in Late 2021

- **Defensive Between July and December 2021**
  - CCI maintained our zero years interest rate duration hedge
  - CCI materially increased portfolio weight to cash (higher red line on RHS)
  - CCI took profits and sold our credit exposures
  - CCI massively increased our use of credit hedges
  - CCI hedged portfolio credit risk using AUD, USD and EUR credit default swaps (CDS) for investment grade credit
  - CCI maintained our portfolio bias to interest-rate hedged government bonds, specifically, semis as our main alpha thematic
- **Defensive through to mid May 2022, then more aggressive**
  - CCI aggressively added credit hedges and then monetised those hedges over time
  - By mid May 2022 we forecast that most of the damage in credit markets had been done. CCI therefore took profits on hedges
  - CCI commenced pivoting back into credit to capture a ~75-150bps increase in credit spreads in senior, T2 and AT1
  - CCI has maintained semis exposure as we consider this to be arguably the most attractive fixed-income sector globally with semi spreads now trading at March 2020 levels
  - We are not aware of any other bond sectors trading at March 2020 levels

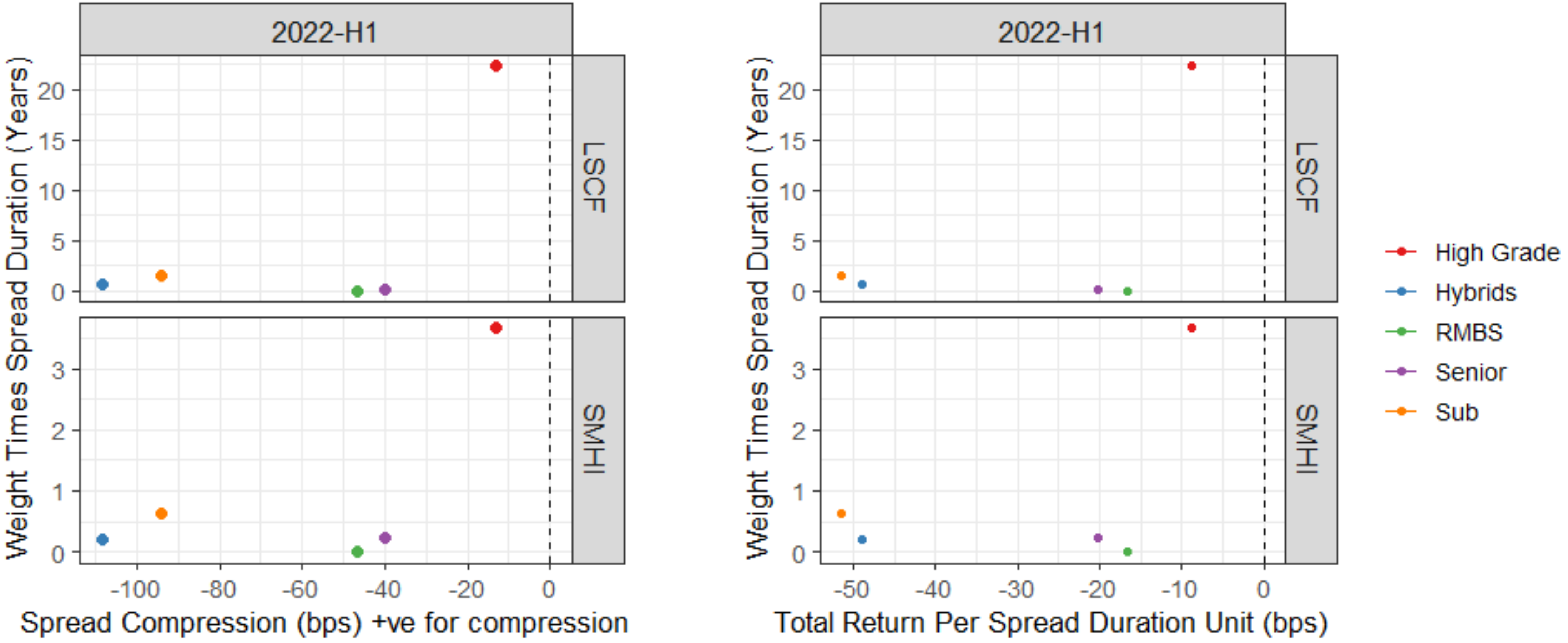




Data Source: Coolabah Capital Investments

Semis were the Best Place to Hide in CY22

- **Analysis shows spread moves and total returns from different asset-classes**
  - CCI was long cash and semis and either short (LSCF, FIXD) or massively underweight (SMAC, SMHI) credit



We Monetised >$6bn of CDS Shorts

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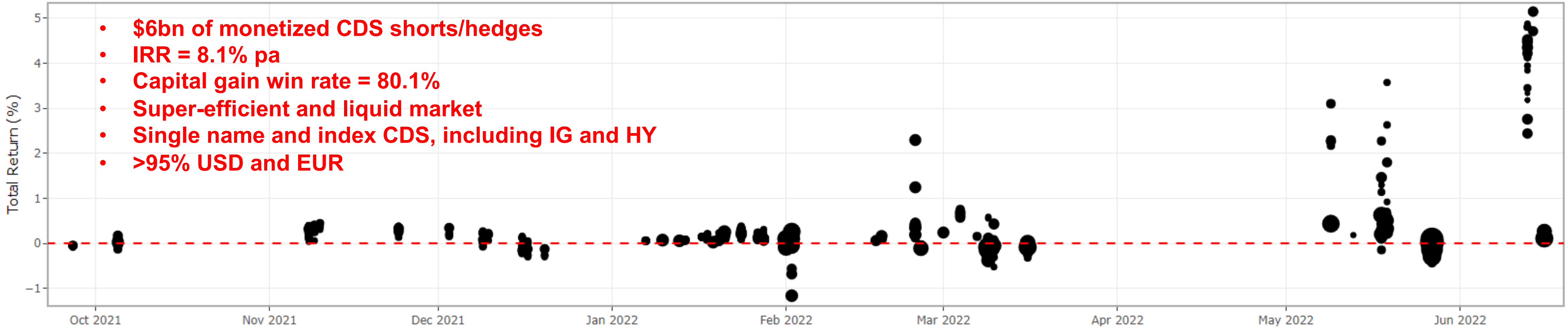
Christopher Joye

- **This screenshot from our internal systems shows every single monetised CDS hedge all portfolios**
  - Hedges in highly liquid AUD, USD and EUR CDS: single name major bank CDS and Investment Grade and High Yield CDS



vwavg Sell Rating	vwavg Sell Tenor	vwavg Spread (bps)	Median Holding Period (days)	Median Trade Size ($MM)	Mean Trade Size ($MM)	Median Cap Gain Per Sell (%)	vwavg Cap Gain Per Sell (%)	vwavg Cpn Return Per Sell (%)	vwavg Margin Change Per Sell (bps)	vwavg Winner Cap Gain (% pa)	vwavg Loser Cap Gain (% pa)	vwavg Cap Gain (% pa)	vwavg Cpn Return (% pa)	vwavg Total Ret (% pa)	Num Sells	Num Cap Wins/Losses	Num Total Ret Wins/Losses	Cap Gain Win % by Trades	Total Ret Win % by Trades	Cap Gain Win % by vwavg Days	Sum Face Value Sell ($MM)
NA	NA	0	10.7	1.8	4.56	0.17	0.25	-0.04	5.76	17.48	-12.06	8.84	-0.95	7.89	1320	1057/263	1016/304	80.1	77.0	84.1	6015

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We Monetised >$2bn of Cash Credit Shorts

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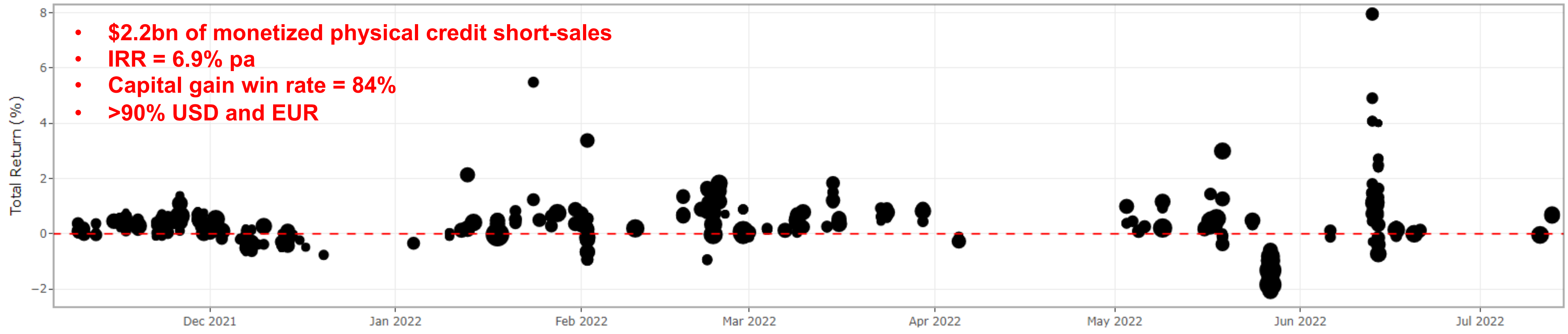
- **This screenshot from our internal systems shows every single short-sale**
    - Shorts in highly liquid AUD, USD and EUR physical credit: focussed on the most liquid, senior-ranking bank paper in USD and EUR



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A	6.71	76.5	21	0.395	0.752	0.50	0.49	-0.17	6.9	21.10	-10.82	15.14	-1.92	13.23	2916	2438/478	2192/724	83.6	75.2	91.5	2193

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Huge Improvement in Yields

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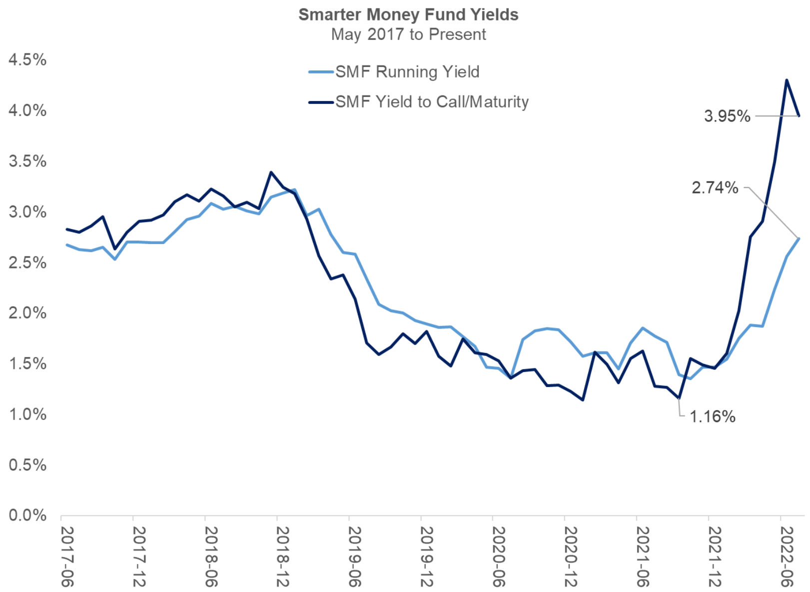
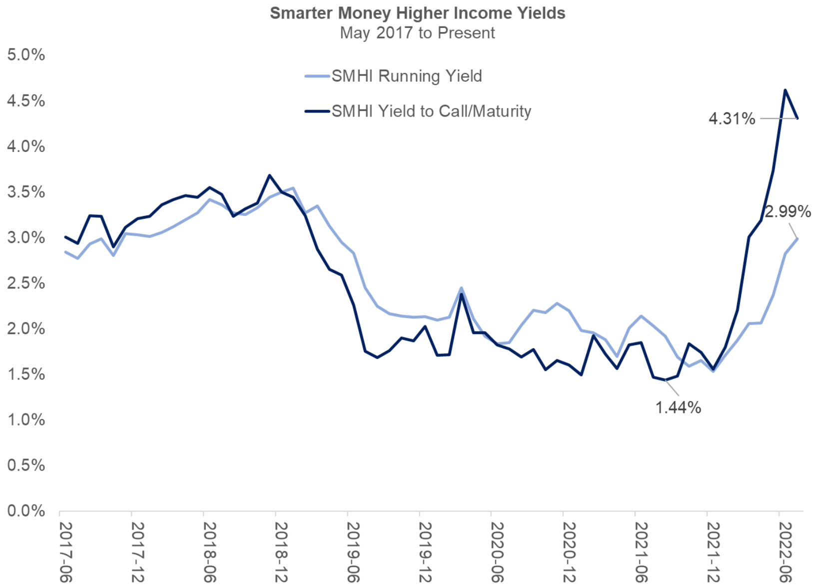
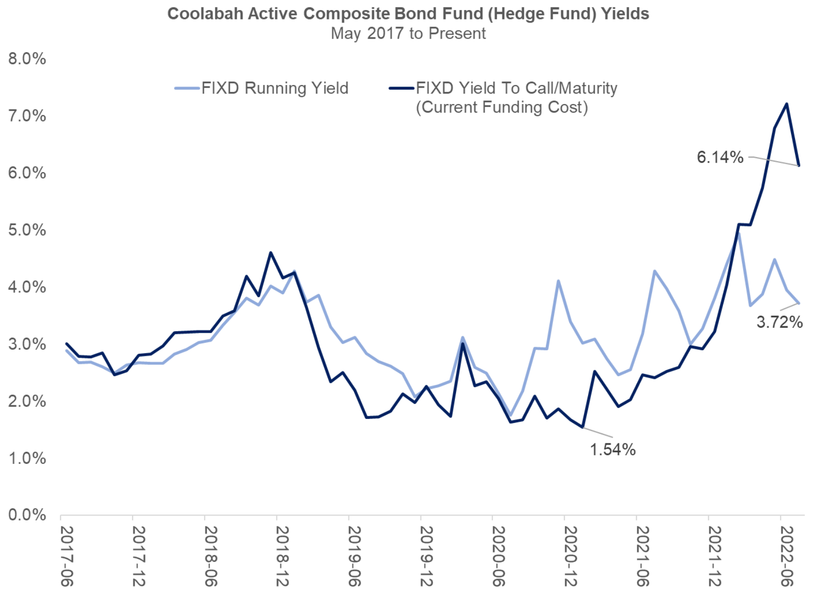
- **Higher yields driven by**
    1. Much higher RBA cash rate (from 0.10% to 1.85% and heading towards 2.50% to 3.00%)
    2. Wider credit spreads (75-150bps higher)
    3. Higher long-term interest rate expectations: market is pricing in terminal RBA cash rate at 3.9%
- **Portfolio yields will continue to improve as the RBA lifts its cash rate and portfolios rotate into credit**







July Update: Unusually attractive new bond issues

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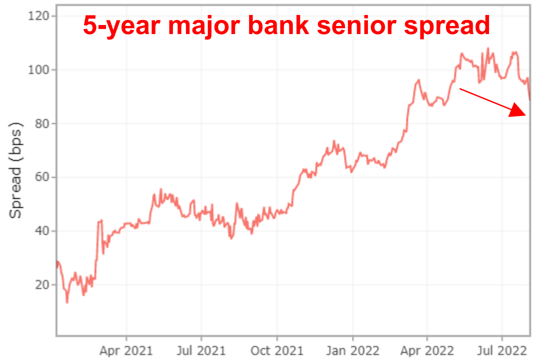
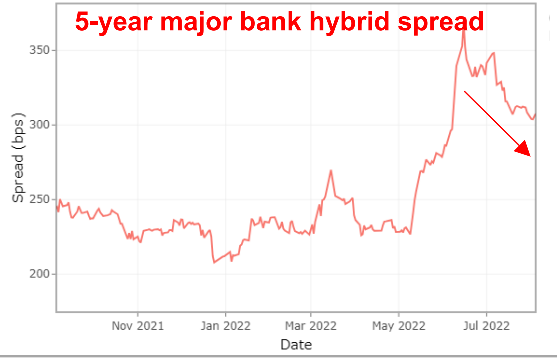
- **5-year NAB Tier 2 bond (BBB+ rated)**
  - 6.4% interest rate (280bps above BBSW)
  - Printed $1.25bn on strong $2.4bn book
  - Credit spread has tightened 31bps on fixed tranche – large capital gains
- **5-year ANZ Tier 2 bond (BBB+ rated)**
  - 5.9% interest rate (270bps above BBSW)
  - Printed $1.75bn on strong $3bn book
  - Credit spread has tightened 17bps on fixed tranche over 2 days – large capital gains
- **3-year NatWest senior bond (A- rated)**
  - 5.0% interest rate (180bps above BBSW)
  - Printed $600m on strong $1.2bn book
  - Credit spread has tightened 17bps on fixed tranche on day 1 – large capital gains
- **3-year Westpac senior bond (AA- rated)**
  - 4.0% interest rate (80bps above BBSW)
  - Printed $2.5bn on strong $3.7bn book
  - Credit spread has tightened 7bps on fixed tranche on day 1 – large capital gains





July Rebound in Performance on Mean-Reversion

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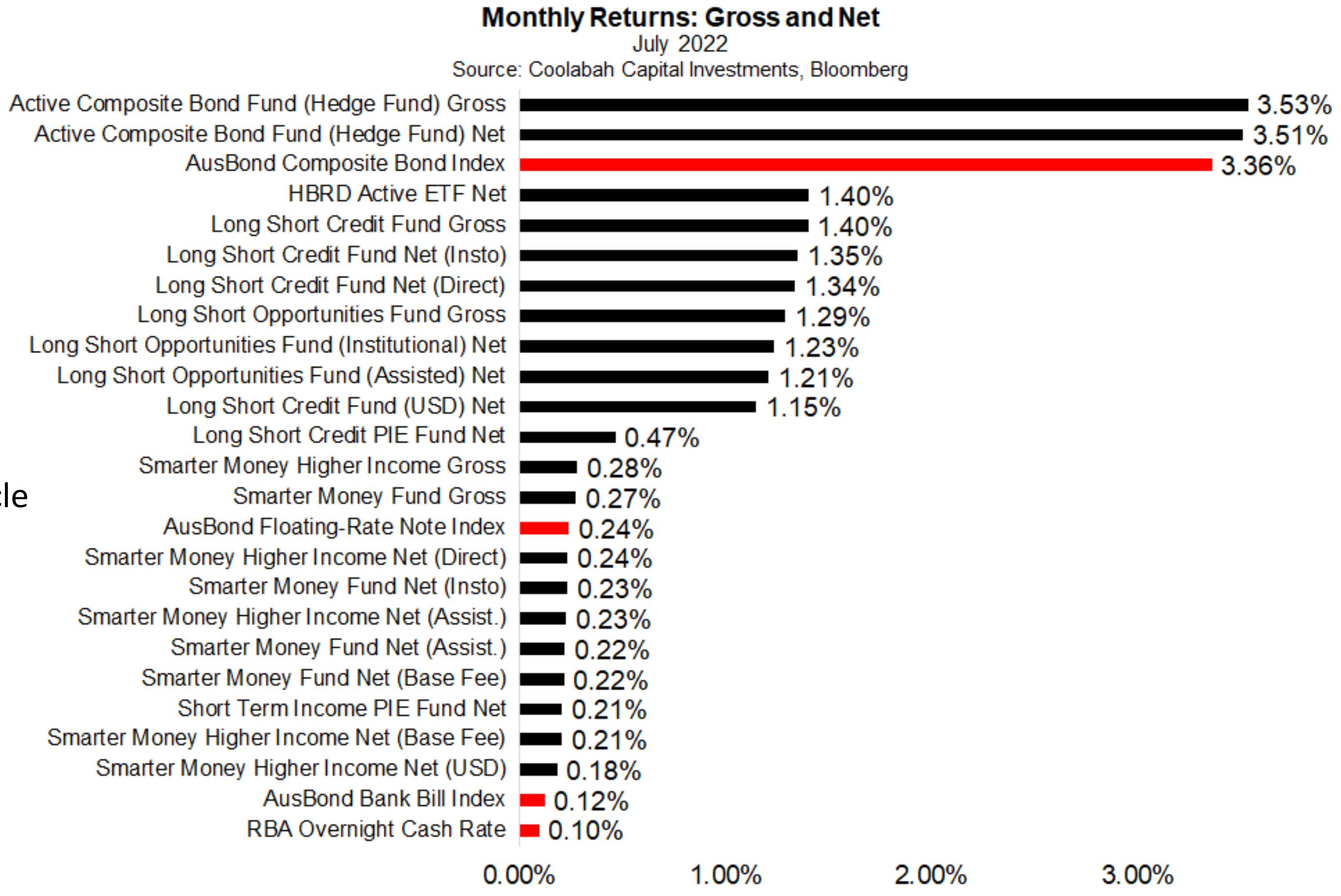
- **Strong investment performance driven by**
    - Mean-reversion in State government bond spreads
    - Mean-reversion in some credit spreads (senior)
    - Mean-reversion in interest rate duration risk
    - Attractive new bond issue concessions (senior, Tier 2)
    - Mean-reversion in swap spreads
    - New long/short Commonwealth bond strategy performing
    - High underlying portfolio yields (ie, income)
- **CCI's core views/forecasts**
    - We like certain credit spread sectors here (Tier 2, new issues)
    - We like State government bond spreads
    - We are neutral on hybrids
    - We are negative on RMBS
    - We are negative on high yield – forecasting a global default cycle
    - We think markets are fully pricing in interest rate increases
    - We forecast slowing global activity and a US recession
    - We forecast a 15-25% correction in Aussie house prices

Name	SMF	SMHI	FIXD	HBRD	LSCF
Liquidity	Daily	Daily	Daily	Daily	Daily
Av. Rating	AA-	A+	AA-	BBB-	AA-
Interest Rate Duration	0 years	0 years	6.3 years	0 years	0 years
Rolling Yield	**2.7%**	**3.0%**	**3.7%**	**4.9%**	**7.2%**
Yield to Call/Maturity	**4.0%**	**4.3%**	**6.1%**	**5.8%**	**12.2%**



Fixed-Income Dilemma: Add-Value or Add Risk?

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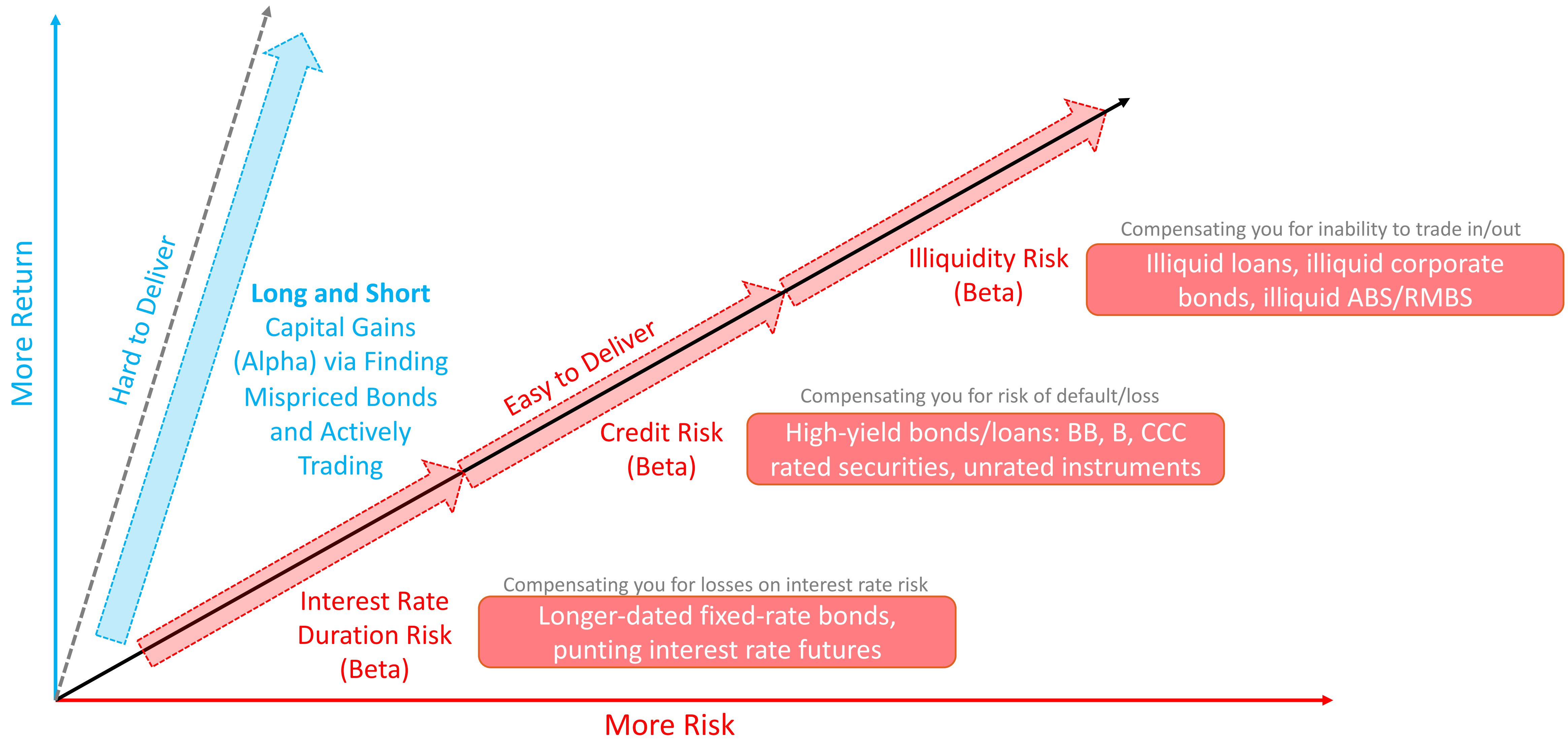

Persistent Alpha: 96% Long Win Ratio in $37bn sales

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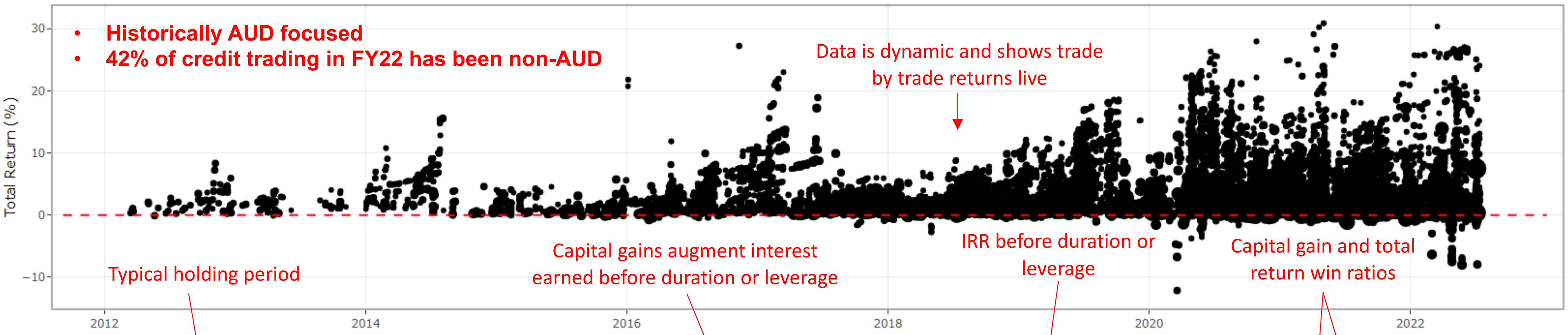
CCI's quant lab



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A+	5.78	86.9	46	0.5	1.08	0.39	0.43	0.91	-11.6	12.10	-4.78	9.70	2.39	12.09	34040	29568/4472	32615/1425	86.9	95.8	87.2	36809

vwavg Sell Rating	vwavg Sell Tenor	vwavg Spread (bps)	Median Holding Period (days)	Median Trade Size ($MM)	Mean Trade Size ($MM)	Median Cap Gain Per Sell (%)	vwavg Cap Gain Per Sell (%)	vwavg Cpn Return Per Sell (%)	vwavg Margin Change Per Sell (bps)	vwavg Winner Cap Gain (% pa) Via median Holding Period	vwavg Loser Cap Gain (% pa) Via median Holding Period	vwavg Cap Gain (% pa) Via median Holding Period	vwavg Cpn Return (% pa)	vwavg Total Ret (% pa) Via median Holding Period	Num Sells	Num Cap Wins/Losses	Num Total Ret Wins/Losses	Cap Gain Win % by Trades	Total Ret Win % by Trades	Cap Gain Win % by vwavg Days	Sum Face Value Sell ($MM)
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Updated SMHI Fund Targets in FY23

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- **The Smarter Money Higher Income Fund (SMF) targets returns above the RBA cash rate + 1.5% pa net of fees**
  - **Very low interest rate risk**: average interest rate duration is circa 0 years (ie, SMHI is a floating-rate portfolio)
  - **Very low credit risk:** average credit rating is A+ (same as Suncorp)
  - **High liquidity:** focuses on holding assets with proven daily liquidity
  - **Very high current running yield = 3.0% pa**
  - **Very high current yield to maturity = 4.3% pa** (based on market's future RBA cash rate expectations)

Possible FY23 Pre-Fee Return Scenario Target based on CCI Credit Spread Forecasts
Note: Disclaimer

	Benchmark Spread Duration	Current Benchmark Spread in Basis Points (bps)	Historic Average Spread Level Since 2014 (bps)	Expected Benchmark Spread Target (bps)	Gross Return Contribution over FY23
Government Bond Trading	10.0	60	35	30	3.39%
Senior Bond Trading	5.0	110	79	90	0.21%
Tier 2 Bond Trading	5.0	270	189	205	2.90%
Hybrid Trading	5.0	340	346	310	0.62%
Total Scenario Return					**7.24%**
Av. RBA Cash Rate					2.92%
Spread over RBA					4.32%

Source: Coolabah Capital Investments; Note: analysis assumes portfolio has benchmark spread duration and market interest rate expectations are correct

Updated Active Comp Bond Fund (FIXD) Targets in FY23

- **The Active Composite Bond Fund (FIXD) targets returns above the AusBond Composite Bond Index net of fees**
  - **High interest rate risk**: average interest rate duration is circa 6.3 years (ie, FIXD is a fixed-rate portfolio)
  - **Very low credit risk:** average credit rating is AA- (higher than CBA, same as the Victorian government)
  - **High liquidity:** focuses on holding assets with proven daily liquidity
  - **Very high current running yield = 3.7% pa**
  - **Very high current yield to maturity = 6.1% pa** (based on current funding costs and market's future RBA cash rate expectations)

Possible FY23 Pre-Fee Return Scenario Target based on CCI Credit Spread Forecasts
Note: Disclaimer

	Benchmark Spread Duration	Current Benchmark Spread in Basis Points (bps)	Historic Average Spread Level Since 2014 (bps)	Expected Benchmark Spread Target (bps)	Gross Return Contribution over FY23
Change in Interest Rates	5.4	307	223	250	3.22%
Government Bond Trading	10.0	60	35	30	8.76%
Senior Bond Trading	5.0	110	79	90	0.23%
Tier 2 Bond Trading	5.0	270	189	205	4.28%
Total Scenario Return (after repo costs)					**13.89%**
Av. RBA Cash Rate					2.92%
Spread over RBA					10.97%

Source: Coolabah Capital Investments; Note: analysis assumes portfolio has benchmark spread duration and market interest rate expectations are correct

Updated Long Short Credit Fund Targets in FY23

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- **The Long Short Credit Fund (LSCF) targets returns above the RBA cash rate + 4% pa net of fees**
    - **Very low interest rate risk**: average interest rate duration is circa 0 years (ie, LSCF is a floating-rate portfolio)
    - **Very low credit risk:** average credit rating is AA (higher than CBA, same as the Victorian government)
    - **High liquidity:** focuses on holding assets with proven daily liquidity
    - **Very high current running yield = 7.2% pa**
    - **Very high current yield to maturity = 12.2% pa** (based on current funding costs and market's future RBA cash rate expectations)

Possible FY23 Pre-Fee Return Scenario Target based on CCI Credit Spread Forecasts
Note: Disclaimer

	Benchmark Spread Duration	Current Benchmark Spread in Basis Points (bps)	Historic Average Spread Level Since 2014 (bps)	Expected Benchmark Spread Target (bps)	Gross Return Contribution over FY23
Government Bond Trading	10.0	60	35	30	22.72%
Senior Bond Trading	5.0	110	79	90	0.71%
Tier 2 Bond Trading	5.0	270	189	205	5.63%
Hybrid Trading	7.0	340	346	310	2.14%
Total Scenario Return (after repo costs)					**20.60%**
Av. RBA Cash Rate					2.92%
Spread over RBA					17.68%

Source: Coolabah Capital Investments; Note: analysis assumes portfolio has benchmark spread duration and market interest rate expectations are correct

CCI

Neutral-to-Positive Major Bank Senior Spreads

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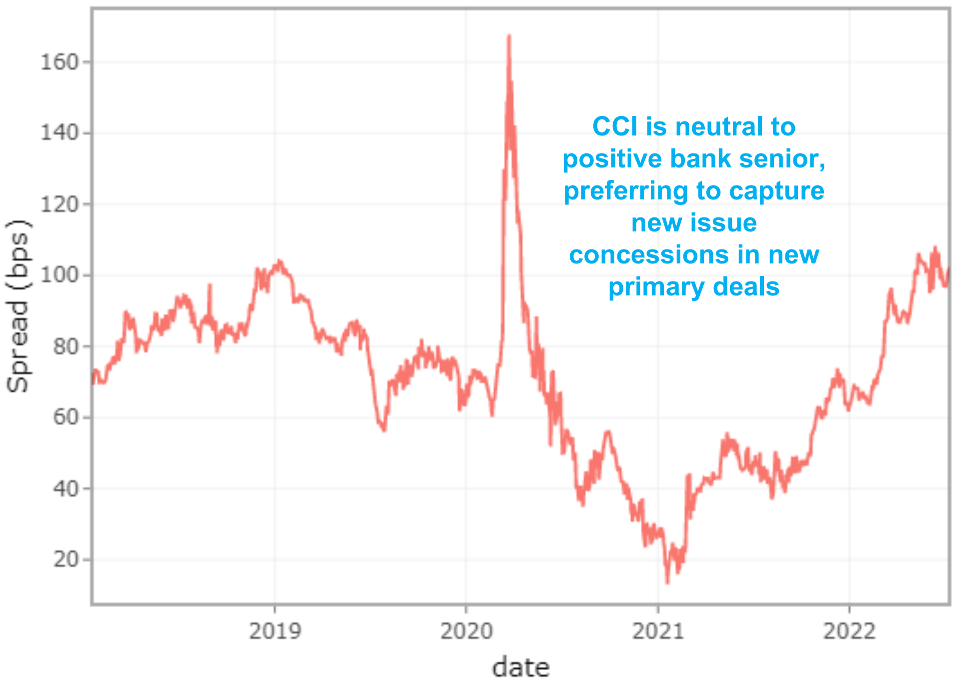
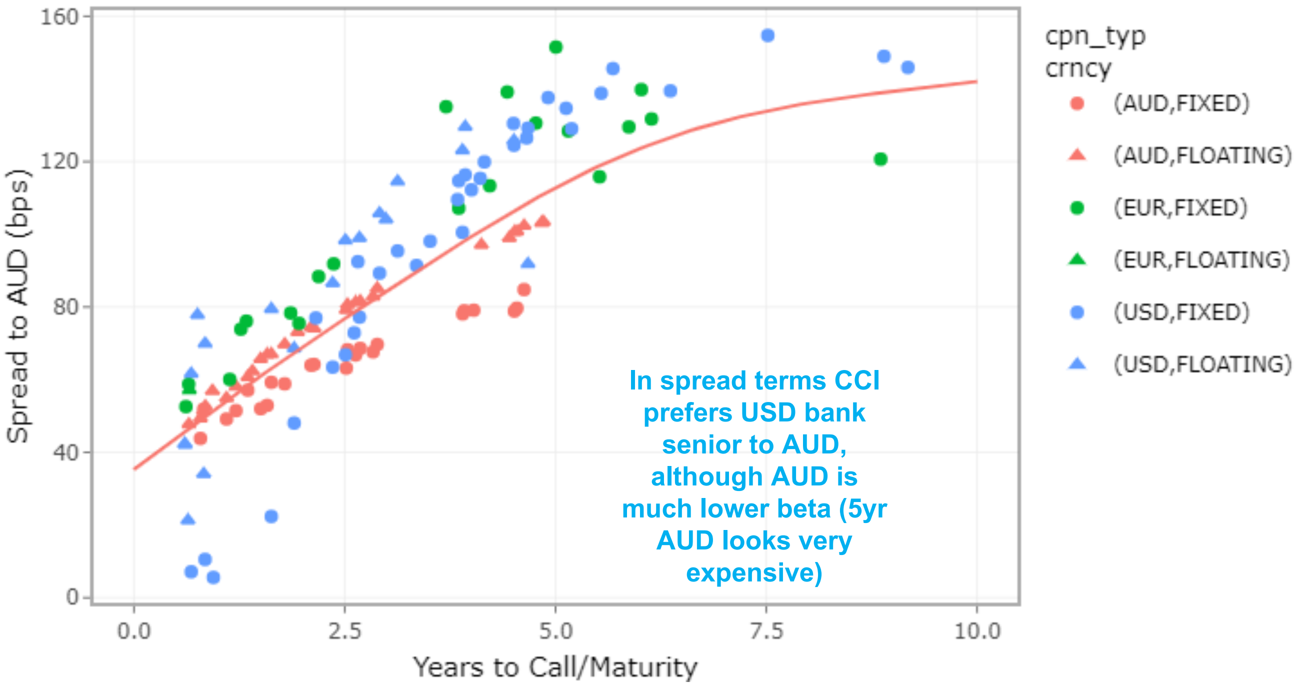
Christopher Joye

- Screenshots from CCI's internal systems showing our custom indices
- 5-year major bank senior bonds in AUD (LHS) trading at 95bps over BBSW vs 79bps average since 2014 (post Basel 3 period)
- Ostensibly cheap, but biggest buyers of bank senior bonds were banks themselves using the $140bn Committed Liquidity Facility
- CLF is shutting down, denying market a key buyer base – negative for spreads, hence CCI's shorts/hedges in bank senior looking for spreads to increase from 25bps over BBSW in 2021 to 70-125bps over
- We are neutral to positive bank senior, preferring covered bonds and shorter dated 3-year paper in AUD

5-year major bank senior bond index in spread above BBSW terms



AUD, USD, EUR major bank senior bond spreads hedged back to BBSW



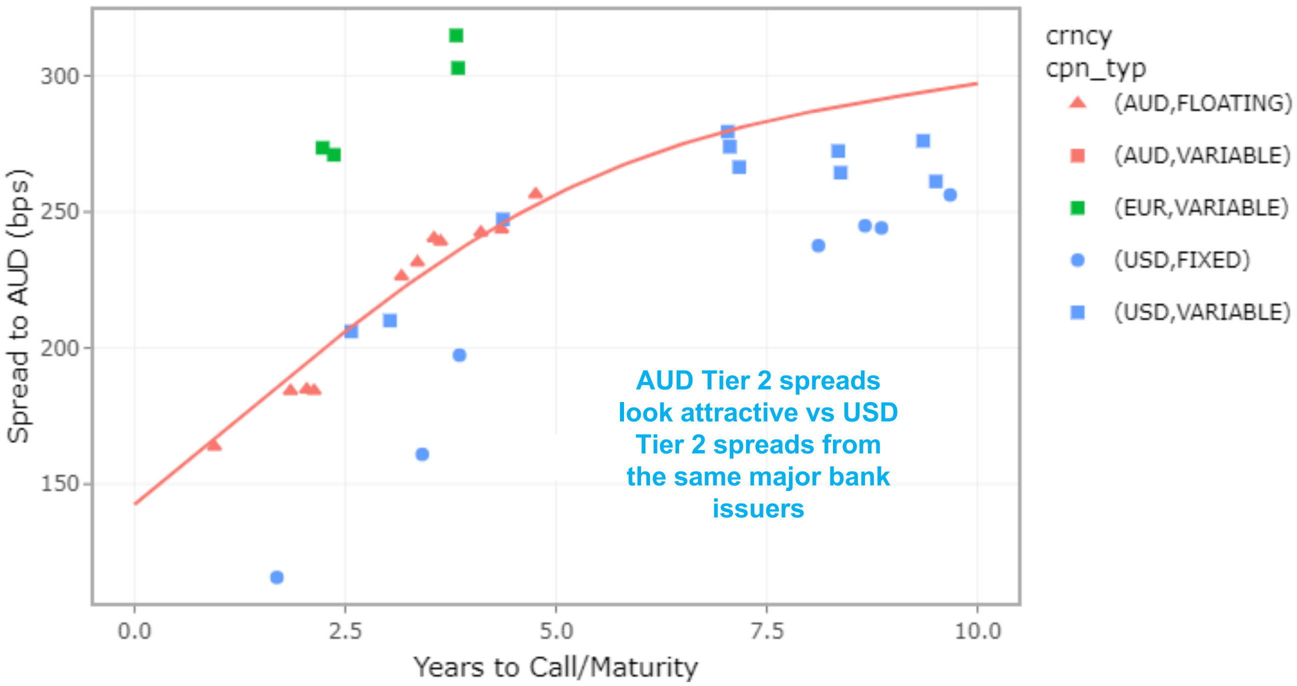
Very Positive Major Bank Tier 2 Spreads

ALPHA MANAGER 2019
Christopher Joye

- Screenshots from CCI's internal systems showing our custom indices
- 5-year major bank Tier 2 bonds in AUD (LHS) trading at 263bps over BBSW vs 189bps average since 2014 (post Basel 3 period)
- Also trading at 2.53x the 5-year major bank senior index spread, which is historically attractive
- Very cheap, which is why CCI has been gradually adding in both secondary and primary
- AUD Tier 2 spreads (RHS) also look quite attractive relative to the USD market (EUR market is broken as ECB QE ends)
- We are very positive bank Tier 2, although we do think spreads could drift wider by another 25bps

5-year major bank Tier 2 bond index in spread above BBSW terms

AUD, USD, EUR major bank Tier 2 bond spreads hedged back to BBSW



Neutral Major Bank Hybrid Spreads

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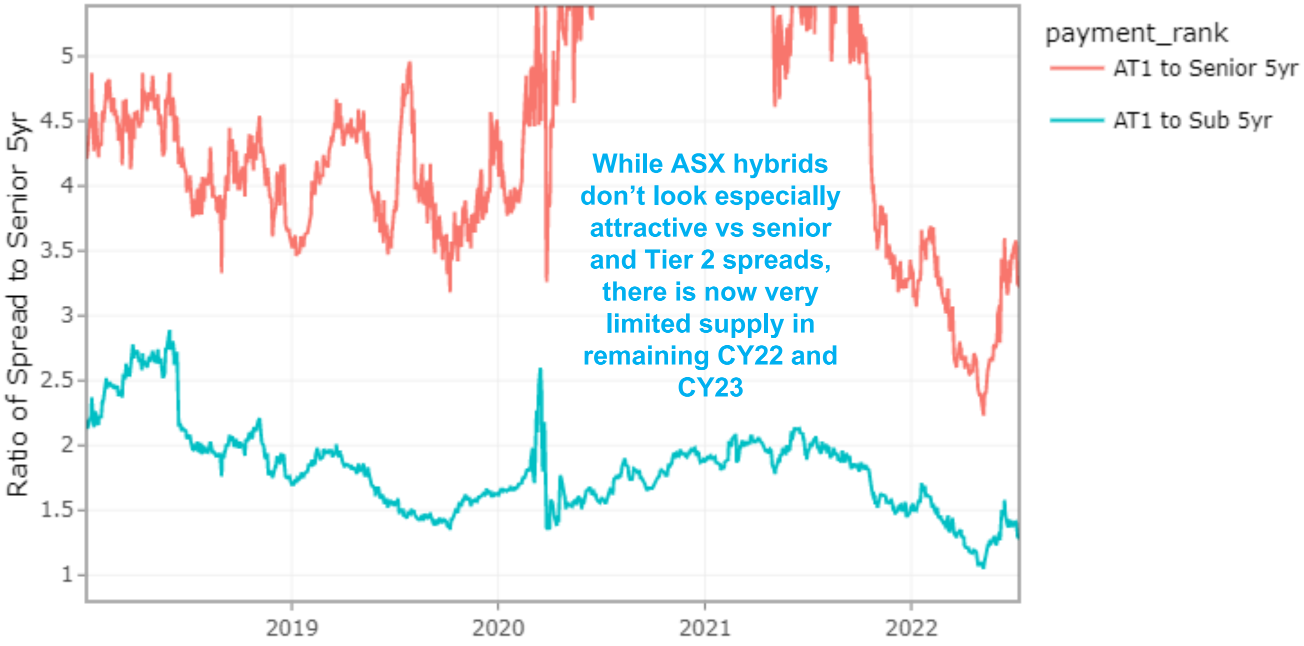
Christopher Joye

- Screenshots from CCI's internal systems showing our custom indices
- 5-year major bank AT1 hybrids in AUD (LHS) recently trading at 308bps over BBSW vs 346bps average since 2014 (post Basel 3 period)
- Looks average relative to historical spreads, noting that 3mth BBSW has surged from 0.0% in 2021 to 2.2% today: BBB- rated major bank hybrid running yields have jumped from circa 2.1% in December 2021 to 5.3% today
- But AT1 only trading at 1.2x times major bank Tier 2 spreads and 3.3x major bank senior spreads (RHS)
- Mitigated by huge improvement in major bank equity (CET1) ratios, which have jumped from <5% in 2007 to 11-12% today
- We are neutral on AT1 bank hybrids at current spreads, capturing new issue concessions in primary markets (nb: very little supply left in CY22 and CY23)

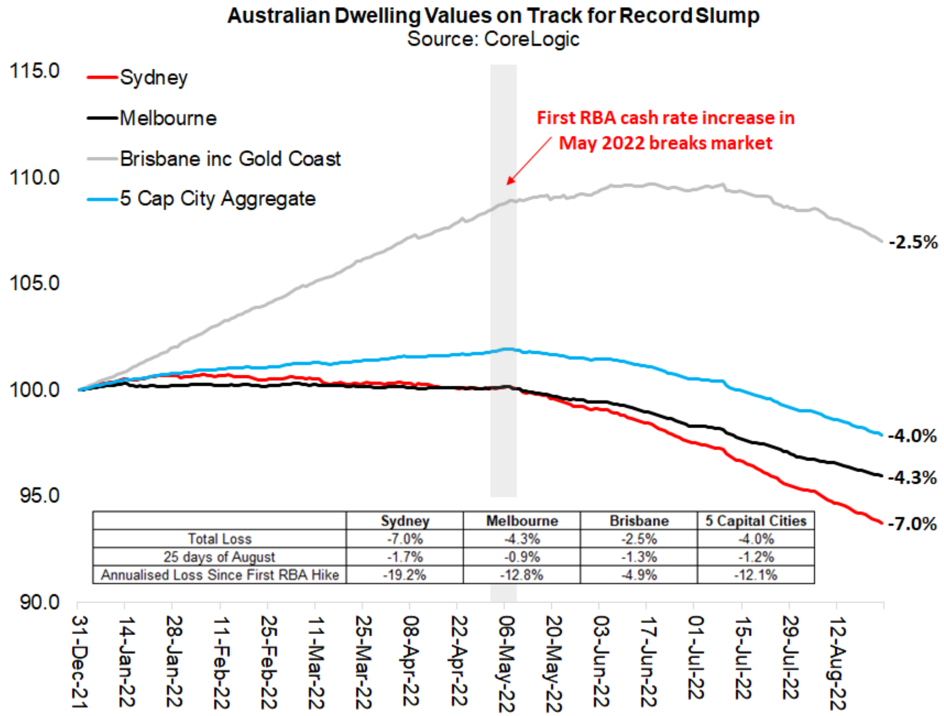
5-year major bank AT1 hybrid index in spread above BBSW terms

5-year major bank AT1 hybrid spreads as a multiple of 5-year senior and 5-year Tier 2 spreads

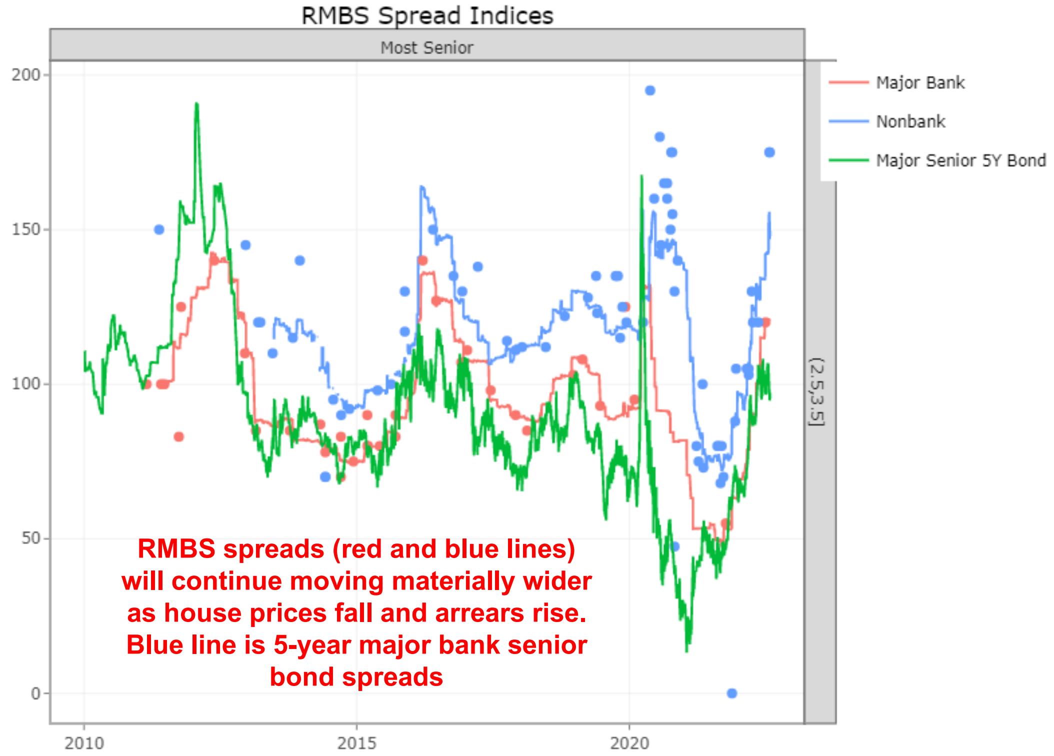


Negative RMBS and Housing

- RHS chart is screenshot from CCI's internal systems showing our custom indices
- In October 2021, CCI forecast house prices will fall nationally by 15-25% after the first 100bps of RBA rate hikes
- House prices are falling at double-digit annualised pace in Syd and Melb—other cities are rolling over with a lag (eg, Brisbane)
- Biggest buyers of RMBS were banks using $140bn CLF, which is shutting down, denying market a key buyer base: negative for liquidity and spreads
- Further, non-bank RMBS lenders have to regularly issue bonds to raise funding, flooding market with RMBS supply. In contrast, banks can use other funding channels, such as bank deposits, to raise money. CCI forecasts some non-banks may sell their businesses as funding costs soar
- CCI is forecasting that home loan LVRs protecting RMBS will rise alongside much higher arrears—big increase in RMBS risk



	Sydney	Melbourne	Brisbane	5 Capital Cities
Total Loss	-7.0%	-4.3%	-2.5%	-4.0%
25 days of August	-1.7%	-0.9%	-1.3%	-1.2%
Annualised Loss Since First RBA Hike	-19.2%	-12.8%	-4.9%	-12.1%



Very Positive Semis

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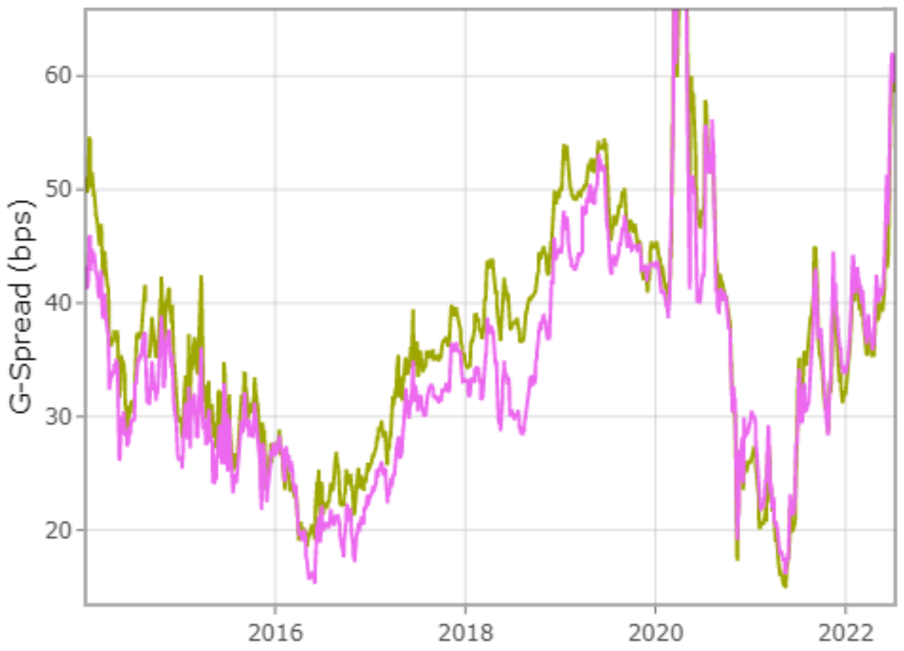
- Chart is screenshot from CCI's internal systems showing our custom indices
- Current 10-year semi spreads are trading at around 60-65bps over Commonwealth bonds, highest level since March 2020 (also very cheap to post Liquidity Coverage Ratio average 10-year semi spread of 33-37bps)
- Only bond sector we know of globally trading at March 2020 levels
- This is despite huge demand drivers and improving supply
  - ❖ CCI estimates banks need to buy $315bn to $570bn of HQLA with a mid-point of $435bn based on APRA liquidity rule changes and a deficiency of High Quality Liquid Assets (HQLA)
    - ▪ UBS estimates $275bn to $375bn (but uses a flawed 125% Liquidity Coverage Ratio estimate – APRA recently confirmed banks run 130% LCRs in line with CCI's estimates)
  - ❖ Translates to $221bn to $440bn of semis buying from banks
  - ❖ This is 4x to 7x times larger than the RBA's $56bn semi QE program, which drove semi spreads down from 40-45bps over Commonwealth bonds to just 15bps over in 2020 and 2021
- Spread widening driven by an extremely unusual shock to the interest rate swap market whereby 10-year swap spreads have exploded to 52bps over Commonwealth bonds, almost double the previous 27bps record since swaps moved to centralised clearing
- Swaps market shock should normalise, reducing swap spreads to 15-25bps over Commonwealth bonds over time. This would make semis much more attractive to banks, which use swaps to hedge interest rate risk when they buy a fixed-rate semi

10-year NSW and Victorian Spreads over Commonwealth Bonds



State Spreads Above Commonwealth Bonds (bps)		
	NSW 10yr spreads	Victorian 10yr spreads
30-Jun-22	59.2	60.7
Average Since 2013	36.6	34.0
Current margin above average	22.6	26.7
March 2020 average	62.4	60.0

Source: YieldBroker; Coolabah Capital Investments

Banks' High Quality Liquid Assets (HQLA) Demand

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Christopher Joye

- Banks hold High Quality Liquid Assets (HQLA), which are Aussie government bonds and cash at the RBA, to protect against a run on the bank's liquidity
- APRA makes them hold HQLA worth >100% of their 30 day cash outflows in a liquidity shock as measured by the Liquidity Coverage Ratio (LCR). Bank boards make them hold at least 125%. In practice, Aussie banks run LCRs over 130%
- Banks used to be able to include the $140 billion Committed Liquidity Facility (CLF) in their LCRs. This is being phased out by APRA in 2022, requiring banks to replace the CLF with government bonds (the CLF was made up of bank bonds, bank loans, and RMBS). So banks have to buy $140bn of government bonds to replace CLF
- When the RBA lent the banks $188 billion of 3-year money via the Term Funding Facility, banks received $188bn of cash on deposit of the RBA—this money is included as a liquid asset in LCRs
- But in 2023 and 2024, banks have to repay the TFF money, which means they lose $188bn of liquid assets. They have to buy $188bn of govt bonds to replace this lost liquidity
- Govt bond buying to replace CLF ($140bn) and TFF ($188bn) = $328bn in total
- As bank balance-sheets grow, they also have to hold more HQLA against their liabilities—so growth drives more HQLA demand
- Finally, when the RBA bought bonds via QE, they also gave banks cash that they held on deposit at the RBA, which is included in bank LCRs
- As bonds mature off the RBA's balance-sheet, banks lose cash held at the RBA, and have to replace this with more HQLA
- CCI estimates banks need to buy $315bn to $570bn of HQLA with a mid-point of $435bn
- Translates to $221bn to $440bn of semis buying from banks given semis are 70% of bank HQLA
- This is 4x to 7x times larger than the RBA's $56bn semi QE program

Table below shows CCI's modelling of bank demand for HQLA as a function of their LCR and assumed Net Cash Outflows (NCOs)

All ADI's Demand for HQLA1 from 31-Dec-21 to 31-Dec-24

Forecast LCR	Forecast NCO Growth qoq: 0.0%	0.5%	1.0%	1.5%	2.0%
125.0%	278	334	394	457	524
127.5%	296	354	415	479	547
130.0%	315	373	$\boxed{435}$	501	570
132.5%	333	393	456	523	593
135.0%	351	412	477	545	617

Banks hold about 70% of their HQLA in the form of semis because they pay much higher yields than Commonwealth bonds

See here:
https://www.livewiremarkets.com/wires/update-on-aussie-bank-liquidity-requirements

State Debt Supply is Falling

- CCI has been consistently ahead of the market in forecasting a material reduction in State government debt supply (ie, semi supply)
- The FY23 debt supply at the start of FY23 for the 5 largest states was \$86bn. By December 2021, this has been downgraded from \$86bn to \$81bn
    - By FY23, this supply expectation had been downgraded further to \$76bn (or by \$10bn)
    - And because of aggressive issuance of record Floating-Rate Notes (FRNs) by NSW and Victoria in May and June, semi supply requirements in FY23 have now fallen to only \$63bn for 5 largest states
- In 2021, CCI convinced the NSW government to dump a plan to issue an extra \$20bn to \$47bn in NSW debt to give this money to TCorp to punt on the global equities market in what would have been a huge levered equities carry trade. This was a major ESG activism victory for CCI
- In 2021, CCI also convinced NSW to draw-down on \$11bn of cash held in a \$26bn Debt Retirement Fund (DRF) to pre-emptively repay NSW debt
- But NSW still has \$15bn of cash in the DRF, which CCI forecasts will be used in the next 12mths to further reduce NSW debt issuance
- And Victoria has just raised \$7.9bn via asset sales to repay debt
- State budget forecasts are generally very conservative and assume sharply lower commodity prices and a housing downturn
- The States benefit from inflation via GST and from wage growth via payroll tax, although they suffer as stamp duty revenues decline and public sector wage costs rise

State Budget Summaries

(\$bn)	FY23 estimate - start of FY22	FY23 estimate - Dec MYEFO	Final FY23 Task	Left to do in FY23
NSW	27.0	25.7	28.2	24.2
VIC	25.8	23.6	21.3	14.1
QLD	19.8	19.8	14.4	14.4
SA	6.7	6.8	6.6	6.6
WA	6.4	5.7	5.1	4.6
TOTAL	85.7	81.6	75.6	63.9