THERE'S NOTHING HALF-HEARTED ABOUT HYBRIDS

Equity-like returns are available in hybrids reflecting robust corporate balance sheets. However, the potential impact of APRA's discussion paper on Australian Tier 1 (AT1) capital instruments poses a risk that could influence returns. By Roy Keenan, Co-Head of Australian Fixed Income

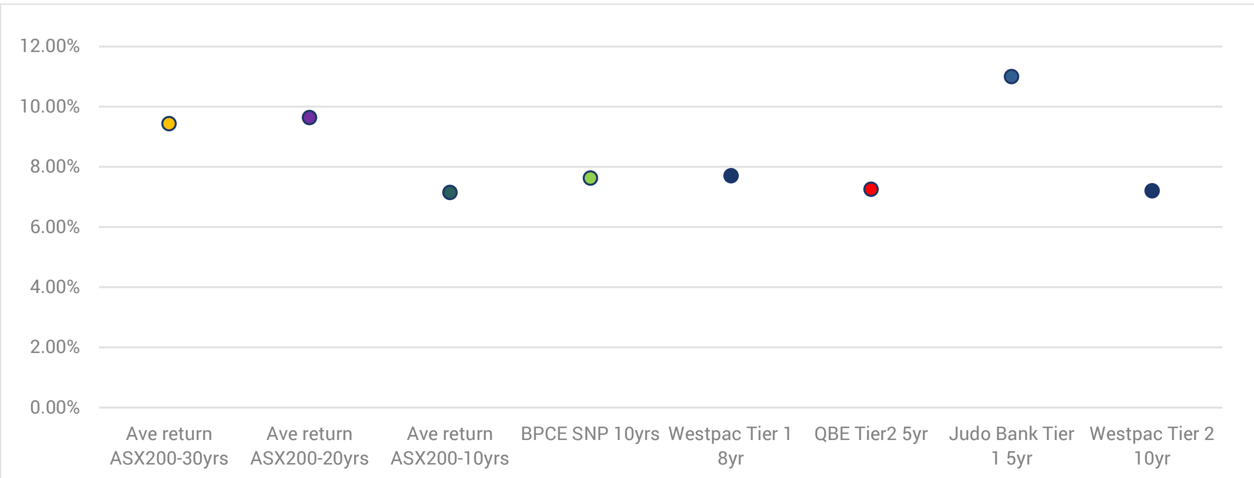
the 2024 outlook hybrids

Why you can expect equity-like returns in hybrid credit

While it's unclear how the macro environment will play out in 2024, the one thing that is certain is that fixed income has its defensiveness back. The returns available in the hybrids sector are equity-like, at a time when bank, insurance and corporate balance sheets remain strong. The only potential concern for bank and insurance hybrids lies in the outcome of APRA's discussion paper released on 21 September 2023, focused on "improving the effectiveness of additional Tier 1 capital instruments". There remains a risk that APRA will act on some of the issues raised in this paper, which could have the potential to shape returns and how we navigate 2024.

The last quarter of 2023 was a busy period in the primary markets in the hybrid sector. There were many deals offering returns in excess of 7% (refer Chart 1), equivalent to Australian equity returns over the last 10 years. We expect these types of returns to continue into 2024, given the outlook for interest rates.

Chart 1 – Hybrid deals in 4th quarter 2023 vs. historical equity returns



Source: Yarra Capital Management, Bloomberg.

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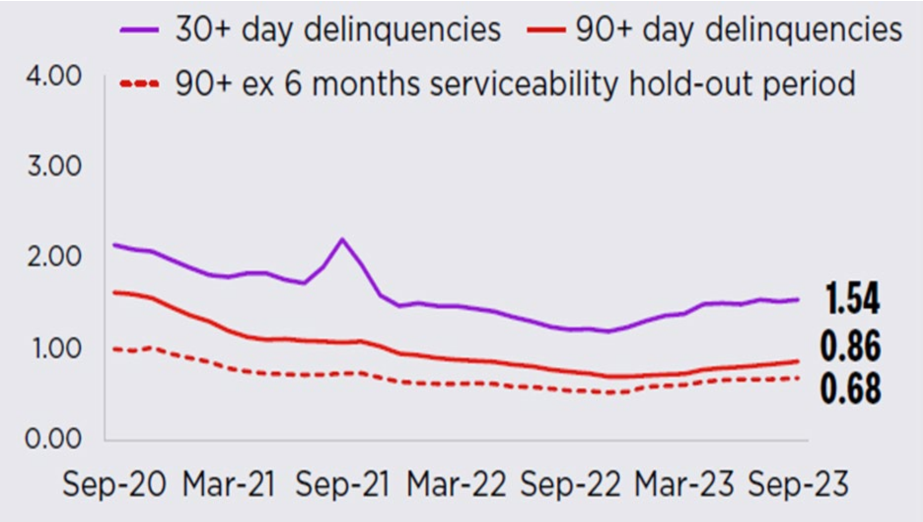
While returns look favourable, how is 2024 shaping up from a risk perspective for banks and insurance companies?

Banks remain well capitalised, as seen in Westpac's recent full-year results which conformed a Common Equity Tier 1 capital ratio of 12.4% compared to 9.1% a decade ago. There is a risk of some capital return to shareholders in 2024, but we don't expect this to be a material issue. The most surprising development has been arrears. Despite anticipating a sharp increase in delinquencies due to central bank tightening in 2022/23, this has not materialised, with arrears still below 2020 levels (refer Chart 2). However, considering monetary policy operates with a lag, the full effects are still working their way through the system, and it seems inevitable that we will see a spike in 2024. Nevertheless, Australia's banks are well positioned for any downside in the economic outlook.

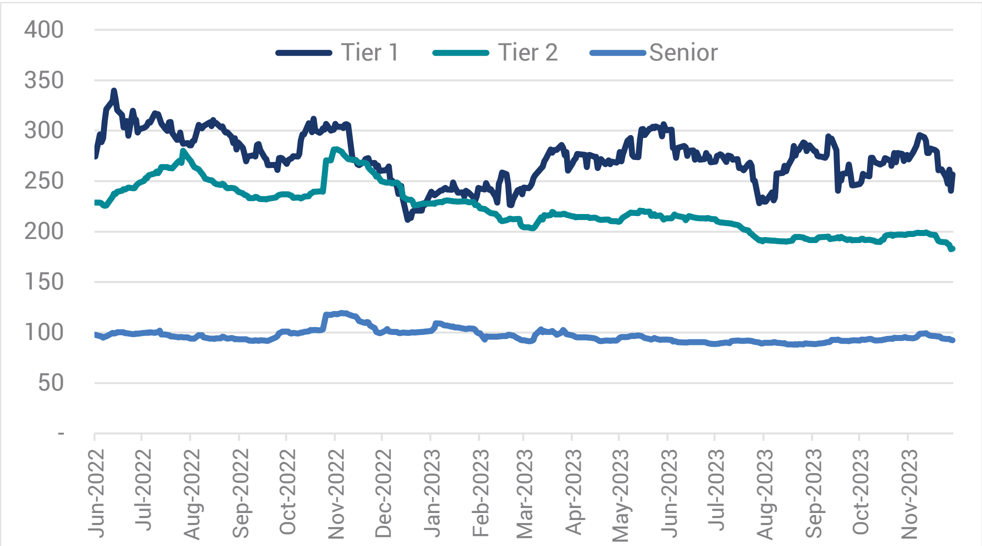
Chart 2 – Australian mortgage delinquencies remain below 2020 levels (%)



Source: Westpac Bank Results – November 2023

One of our key trades for 2023 was our bias to Bank Tier 2 securities over Tier 1 (refer Chart 3), which played out very well for investors in the Yarra Enhanced Income Fund. We expect Tier 2 to continue to outperform into 2024. However, depending on the outcomes of APRA's discussion paper, we may have the opportunity to switch into Tier 1 at some point during 2024.

Chart 3 – Widening Tier 1 spreads are yet to present compelling opportunities



Source: Yarra Capital Management

We maintain our preference for the Insurance sector into 2024, anticipating continued benefits from premium increases, stable volumes and increasing returns on investment books.

We are also optimistic on the outlook for the A-REIT sector. Since the 2020 pandemic, A-REITs have experienced a deterioration in credit quality, especially for those exposed to office spaces. Our research suggests that this sector needs to raise capital or sell assets to repair balance sheets and maintain credit ratings. Raising equity at discounts to net tangible assets or selling assets at deep discounts appears an unfavourable route. We anticipate A-REIT's exploring the option of issuing subordinated debt (hybrids) in 2024 to support their credit ratings. If these deals are priced correctly, we would be keen participants.

Potential outcomes of APRA's paper

Post the release of the APRA paper, we have engaged in discussions with industry participants to gauge their thoughts on the likely outcomes. Opinions vary on what APRA will do, ranging from full implementation to no change from the way the market currently operates. We suspect that the most likely outcome is somewhere in between. If APRA makes sweeping changes, it is clear that it will be more costly for banks to issue AT1 capital in the future.

In forming our outlook for AT1 hybrids in 2024, we assume that APRA implements the majority of the issues raised in the discussion paper. These include:

- Raising Capital Triggers;
- Excluding retail investors by introducing minimum trade size of $500,000 (AT1 only available for wholesale investors); and
- Capping the amount AT1 issuance.

So how does this impact our outlook?

Firstly, we are well positioned given our bias to Tier 2 capital.

Secondly, we would expect banks and insurers to expediate any new issuance or refinancing prior to APRA implementing any changes. Westpac has already refinanced some of their 31/7/24 hybrid. Why will banks do this? It will be cheaper than waiting to issue under the new guidance and would represent the last chance to tap retail investors. We see any move wider in Major Bank AT1 spreads above 300 bps as representing a good entry point.

Despite the great unknown regarding APRA and whether the RBA can manufacture a soft landing for the economy, we suspect that Hybrid spreads will continue to grind in slowly over 2024. The risk-return opportunity in hybrids seems compelling today, and we expect to see strong investor demand throughout 2024.

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Equity-like returns in hybrid credit are set to continue in 2024.

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