



Oz bonds a safe haven for offshore investors

Demand has reached a record level
and foreign holdings are rising

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OFFSHORE investors have turned their attention to Australian government bonds, buying at record levels in the third quarter of this year, a trend that could gather pace next year while the credit rating of European countries remains under a cloud because of burgeoning debt.

Bond investors including central banks from across the world have sought Australian assets as a safe haven. Attracted by Australia's triple-A rating, strong credit quality and relatively attractive investment returns on government bonds, investors have flocked here in recent months.

That is in contrast with Europe. Last week Standard & Poor's warned it might downgrade 15 European countries, including the biggest economies, from their AAA ratings because of their huge levels of debt. If so, those countries would follow the US, which lost its triple-A rating this year.

According to investment bank UBS, balance of payments data released by the Australian

Bureau of Statistics indicates offshore demand for Australian government bonds reached a record level of \$23 billion in the third quarter of this year.

"There has definitely been a step up in buying and we've seen that from our own trading," says Duncan Haig, director of fixed income at UBS.

"From a global perspective, the scarcity of high-quality, triple-A rated debt is making Australia attractive as there has been an increased focus on credit quality given the European debt crisis.

"We are seeing new buyers of government bonds that haven't invested in Australia before, including central banks, whose reserve needs have spiked up since 2007.

"The diversification story (the need to invest in assets outside of Europe) is a powerful one and I think it will be an ongoing source of funding for the Australian government, and I don't see this reversing for the moment. Those offshore buyers are likely to increase their holdings

now that they are invested here."

Haig says total returns on government bond returns are attractive given the Australian dollar is expected to rise further, increasing the value of our securities to offshore investors. Continued growth and strong commodity exports and close connections to Asia will underpin that currency appreciation. "In addition, we are one of the few markets that trades on a positive real yield," he says.

While Australian 10-year bonds yields are trading at about 3.75 per cent, yields on 10-year bonds in many triple-A rated countries sit at 2 per cent or less. That means real yields, or returns after inflation, are zero. "So it looks like a pretty good story for offshore investors," Haig says.

Offshore fund managers are also buying up senior debt issued by Australian banks. US money market funds, which focus on highly rated short-term debt, have reduced their exposure to European banks and reinvested funds in Australian

banks, the Reserve Bank said this week.

"Financial institutions are enjoying good demand for their unsecured senior debt and there seems to be a regular flow of money coming in, with offshore investors happy to buy at current levels as they are seeing these assets as a safe haven," says Ken Hyman, Antares Fixed Income investment manager.

"We're seeing demand in short-end debt and buying from MMFs has been substantial.

"That has resulted in an out-performance of Australian bank debt relative to US banks and a massive outperformance relative to European banks."

Stephen Nash, director of strategy and market development at FIIG Securities, says while there has been some increased buying of bank debt, that may diminish next year as some offshore funds approach their buying limits.

"That may see spreads move out on a relative value basis as they are looking a bit expensive," he says.



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DUNCAN HAIG
UBS DIRECTOR OF FIXED INCOME



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Duncan Haig of UBS says ‘there’s definitely been a step-up in buying’ by offshore investors