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'In the eye of the storm': investors see trouble

Bonds

William McInnes

Huge demand for Australian government bonds should give the equity market chills because it is a sign that investors think the economy will get worse before it gets better, according to one of the market's biggest homegrown bond funds.

Jamieson Coote Bonds took part in Tuesday's $17 billion bond auction from the Australian Office of Financial Management, its second-biggest and part of an ambitious debt issuance strategy to fund the budget deficit.

The November 2025 bonds were sold with a 0.25 per cent coupon and a 0.495 per cent yield to maturity. The order book totalled $50.6 billion, meaning more than $30 billion of offers were knocked back.

"There's still a huge demand for bonds even in a low yield environment," said JCB chief investment officer Charlie Jamieson. "They are incredibly low yielding instruments but they're still generating positive, powerful returns."

While risk markets have rallied sharply following the equity sell-off through February and March on a business-as-usual mentality, bonds haven't bought into the recovery optimism.

"[Bond markets] are somewhat cautious about the outlook and that insolvency phase and whether this unemployment might become permanent for a lot of folks," Mr Jamieson said.

"The reality of it is we're really in the eye of the storm. We're still in disaster relief funding mode."

Bond markets were quick to price in a gloomy outlook for the global economy on the back of the spreading COVID-19 pandemic and have not wavered – unlike shares, which have flipped to extreme bullishness since March. This has unleashed a Robin Hood rally fuelled by day traders and enormous liquidity.

JCB remains bearish on the Australian dollar because of its exposure to global risk sentiment, which means it rallies when Wall Street does.

The Australian dollar traded above US70¢ yesterday, but with Australia's relationship with China increasingly strained, Mr Jamieson is doubtful of holding these levels.

"I think it's much harder from here to have much conviction on the currency," the investment manager said. "I think we'll settle somewhere in the US65¢ to US70¢ range."

Even so, JCB believes Australian bonds are a buy as the highest-yielding developed market, and among the last to hold onto its triple-A credit rating.

Negative rates are one possibility floated by JCB, although many market economists still believe the Reserve Bank would never embrace such a policy.

"The RBA have this history of making these statements and then back tracking. They had said they didn't want to do QE and if you believed them then, you've had the shirt removed from your back," Mr Jamieson said.

"They've said they don't want to do negative rates, but they might have to if we're going into a further deflationary phase."

Investors have shown a strong desire to buy Australian debt. Two months ago the AOFM launched Australia's biggest-ever debt raising: a record $19 billion issue of 10-year bonds in May that priced at a 1.025 per cent yield.

"We're going to have an awful lot of bonds on issue for an awful long time and we're going to try and monetise that on behalf of our clients as best as possible," Mr Jamieson said.

"I'm really encouraged by the way the bond market is behaving."

JCB cleared space in its portfolio ahead of the five-year issuance and has made room at the longer-end of the curve in expectation of bond issuance with longer maturities.

The AOFM has flagged to investors it intends to syndicate a new 30-year bond in the week starting July 27.

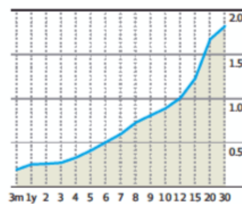
"We did lighten up in the long end ahead of the end of financial year after the AOFM articulated they'd like to do a new bond. We've benefited from that underperformance of that long end, which was nice."

The new offerings are particularly attractive for bond investors, given their cheap issuance.

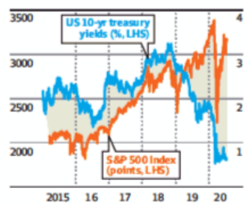
The support from the Reserve Bank of Australia at the front end of the curve and the presence of a large number of price-insensitive buyers meant bonds were going to remain strong options for asset managers.

"The new 30-year bond is a very big deal because once it goes into the index, all the passive managers have to buy it at month end and have to pay more to buy it than we did," Mr Jamieson said.

Australia yield curve (%)



S&P 500 v US 10-yr treasury yields



Australia bond yields (%)

SOURCE: BLOOMBERG, JCB

Price volatility has oil producers over a barrel

Analysis

Robert Guy

It takes some guts to outline a view on the trajectory of oil prices after having just dusted $7.5 billion of shareholder value.

But that was the folly inflicted on shareholders of Woodside Petroleum and Origin Energy after they put a price tag on the very cost of not being able to foretell the future of oil prices.

Putting aside the IQ-insulting nonsense of "non-cash" impairments, Woodside's and Origin's write-downs of $6.3 billion and $1.2 billion of past real cash investments shows how quickly it can turn pear-shaped when visions of strong demand and prices get crushed by the reality of a surfeit of supply and dearth of demand.

The job of an energy company chief executive is a tough gig. Big licks of capital, long lead times, flighty commodity prices, new technologies, and simmering geopolitical tensions can make for messy outcomes.

And messy is what 2020 has been for the oil and gas industry as Saudi Arabia and Russia's ill-timed war for market share smashed head on into collapsing oil demand as COVID-19 forced more than 90 per cent of global GDP into some form of lockdown.

While Brent crude oil prices have bounced back to above $US40 a barrel thanks to output cuts and the gradual easing of restrictions in big energy consumers like China and the US, the gathering pace of industry write-downs shows the wake-up call forced upon the industry by the upheaval of the past four months.

Energy industry executives have to be vocationally bullish to justify the allocation of billions of dollars of shareholder capital in long-dated projects. While expectations have been tempered, the industry is still eyeing a recovery in prices over the coming five years.

What's interesting is the difference between the trajectory of oil prices assumed by energy companies such as Woodside and Origin, and oil traders.

Woodside sees a Brent oil price at $US65 a barrel in 2025, while Origin sees the global benchmark trading at $US61 a barrel.

But oil traders have 2025 oil futures trading around $US53 a barrel, or 13 per cent below Origin's conservative forecast and 18 per cent below where Woodside sees prices half a decade from now.

Not that the futures market has smothered itself in glory when it comes to being prescient about the future price of oil.

Five years ago, the futures market was pricing in a Brent oil price today of around $US71 a barrel.

Key to the recovery in oil prices have been the co-ordinated supply cuts among members of the Organisation of the Petroleum Exporting Countries and Russia.

This week's meeting of the cartel and its allies requires a choice between trimming production cuts and dampening oil prices, or not cutting and losing market share to US producers.

OPEC has taken a more upbeat view on the outlook for demand in its new oil monthly report. It expects world oil demand to drop 8.9 million barrels a day in 2020 to a daily average of 90.7 million barrels a day.

It then expects oil demand to jump 7 million barrels a day in 2021, a historically high increase in global demand. China's demand is expected to increase by 1.1 million barrels a day in 2021.

The bad news for the oil industry is that 97.7 million barrels a day is still short of the 99.67 million barrels a day recorded in 2019.

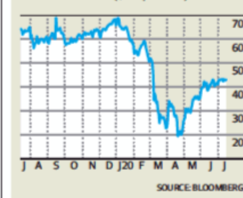
And oil bulls take note. OPEC warns its 2021 forecasts assume no major COVID-19 outbreaks, an optimistic display of conviction given the growing number of cases in the US.

There is one glimmer of hope for the bulls. The deep cuts to spending triggered by the crisis – OPEC forecasts US shale spending of $US63 billion in 2021 compared with $US100 billion in 2014 – may just deliver energy companies an upside surprise well beyond their forecast horizons.

The author owns Woodside shares.

Reality check

Brent crude oil ($US/barrel)



SOURCE: BLOOMBERG