Liquid Insight

Rise of the super funds: structural tailwinds for the AUD

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Rates and Currencies Research
Global

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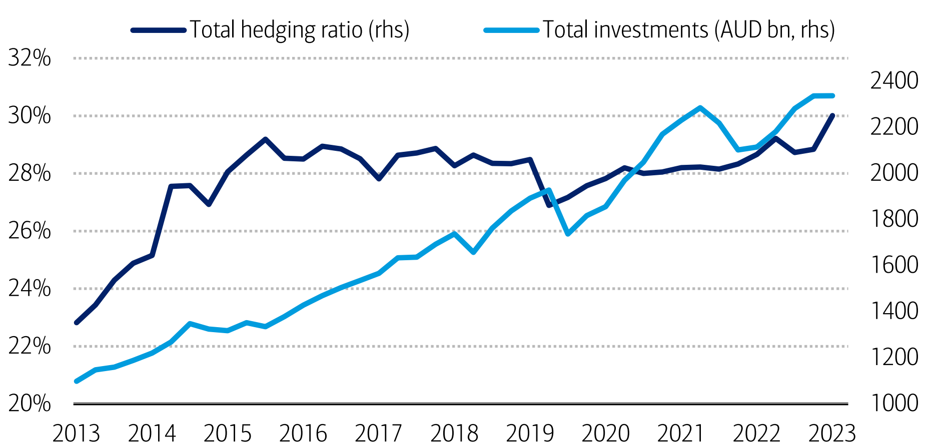
Key takeaways

- Increases to mandatory superannuation contributions have accelerated the growth of Australia's retirement savings pool.
- A larger superannuation pool and current-account surpluses have made AUD a lower beta currency than before.
- A larger super fund complex means larger domestic investor appetite and tighter cross-currency basis in the medium term.

By Oliver Levingston & Adarsh Sinha

Chart of the Day: Super fund assets under management and hedging ratios have been rising
Increases to mandatory employer superannuation contributions have fuelled accelerating AUM



Source: Bof Global Research, Australian Prudential Regulatory Authority (APRA)

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Super to the rescue?

We see a structural tailwind for the AUD from increases to mandatory superannuation (retirement savings) contributions. Rising superannuation AUM has occurred alongside a rise in hedging ratios – annual growth in hedged AUM has averaged 17.6% over the past decade (Chart of the Day). Weak China sentiment has weighed on the currency but the AUD trade-weighted index has traded in a tight range as current account surpluses and improvements in Australia's net international investment position (NIIP) have reduced the beta of the currency (Liquid Insight: AUD can beat its beta 09 January 2024). We see rising superannuation fund balances as supportive of the currency and AUD demand in basis markets, especially if changes to the correlation between international equities and AUD drive hedging demand for superannuation funds' large equities holdings.

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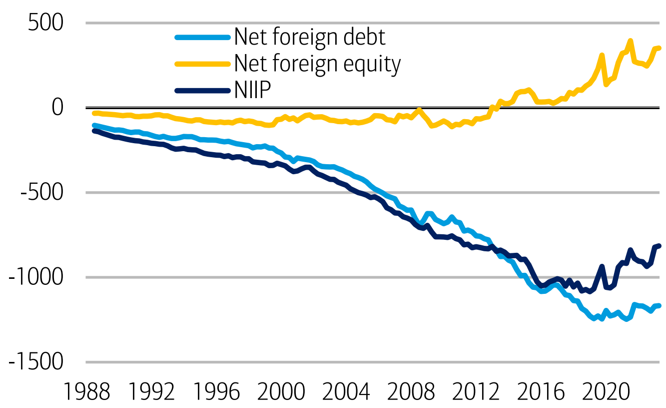
AUM = assets under management

Super structural change

From 2013, employers' minimum contribution to Australian employees' retirement accounts has been increasing. The minimum employer contribution will gradually rise to 12% of an employee's salary by 2025. Coupled with a substantial and, to an extent, unforeseen increase in the working population, an increase to guaranteed superannuation contributions has boosted superannuation system balances significantly.

Rising super balances have helped boost Australia's net international investment position over the past decade (Exhibit 1). Net gains in foreign equity holdings were partly offset by rising fiscal deficits between 2012 and 2019. Pandemic-era policy, including wider deficits and temporary policy that allowed eligible households to withdraw up to $20,000 from their superannuation accounts, saw the NIIP retrace some of these gains. Since 2021, though, unexpected fiscal surpluses have supported a rebound in the NIIP since 2021 (Exhibit 2, Exhibit 3).

Exhibit 1: Net international investment position
Meaningful improvement in Australia's NIIP...



Source: BofA Global Research, Australian Bureau of Statistics (ABS)

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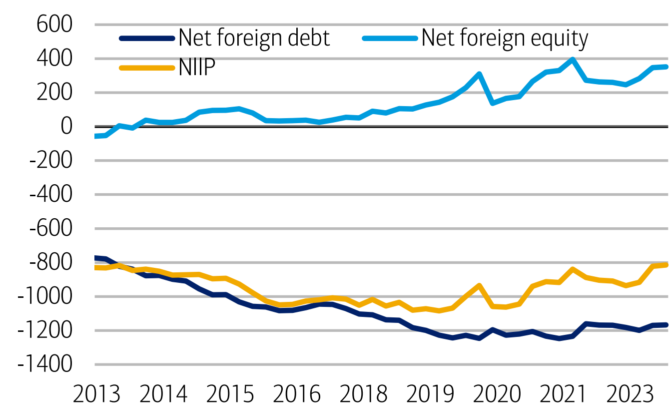
Exhibit 2: Net international investment position since 2013
... driven by foreign equities



Source: BofA Global Research, ABS

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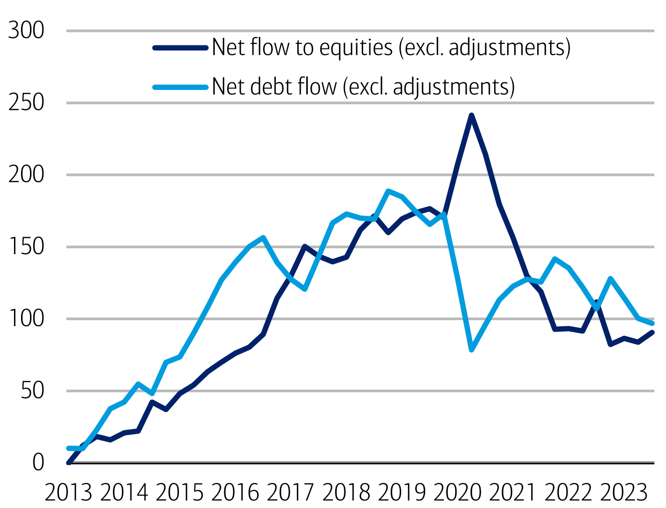
Exhibit 3: Net international equity and debt transactions (excl. FX adjustments)
Fiscal and trade surpluses have supported positive net flows since 2020



Source: BofA Global Research, ABS

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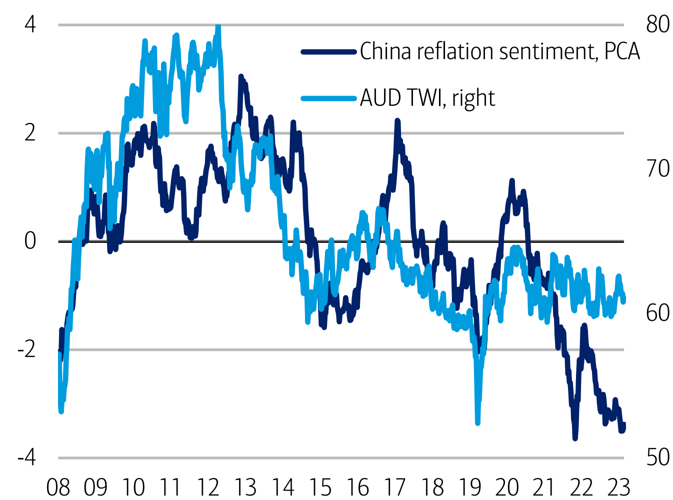
Exhibit 4: China sentiment vs. AUD trade weighted index
AUD has been resilient (in trade weighted terms) to China pessimism



Source: Bloomberg

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Lower beta AUD to drive higher hedging ratios

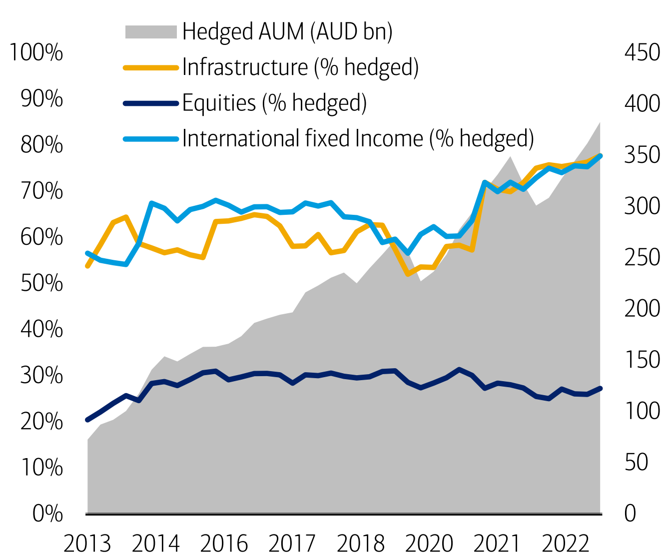
Superannuation funds have increased their hedging ratios at the same time as assets under management have accelerated. Annual growth in hedged AUM has averaged 17.6% over the past decade. We see further increases to hedging ratios as the NIIP improves and the AUD trades at a lower beta to global risk sentiment.

This is already evident in the resilience of AUD TWI (ex USD) to the multi-year China slowdown (Exhibit 4), as well as the sharp compression of implied skew. We have previously argued these are durable trends related to export diversification and improvement in net foreign liabilities (Liquid Insight: AUD can beat its beta 09 January 2024).

If the AUD continues to exhibit a lower beta to risk sentiment, super funds are likely to reduce their unhedged exposure to listed international equities. Hedging ratios have risen over the past year because of an increase in the proportion of infrastructure and international fixed income exposures that are hedged (Exhibit 5). Conversely, hedging of foreign equities fell around the same time as other hedging ratios increased and has remained broadly stable over the past decade. International equities are typically unhedged because the AUD has been correlated with movements in risk assets. In other words, the AUSUSD FX rate acts as a shock absorber during periods of heightened stress and volatility, falling alongside USD equity valuations.

Superannuation funds' allocations to international listed equities are especially large and an increase in hedging ratios would likely have an outsized effect on AUD valuations (Exhibit 6).

Exhibit 5: Hedging ratios by asset class
Fixed income & infrastructure hedging ratios have increased markedly



Source: BofA Global Research, APRA

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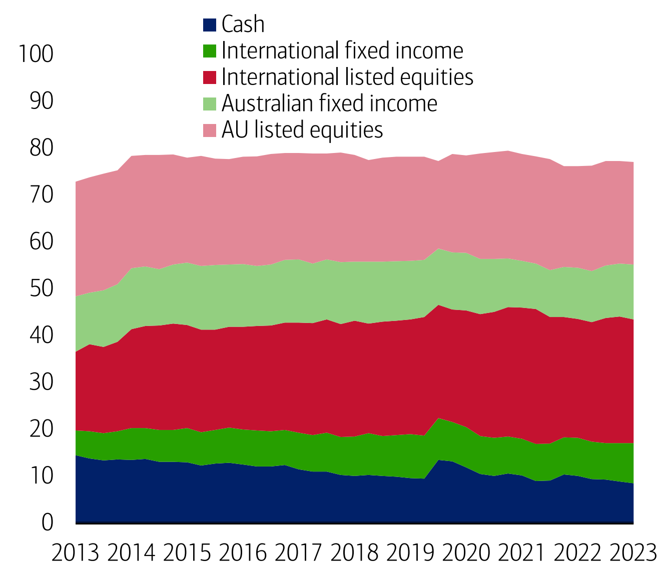
Exhibit 6: Superannuation funds asset allocation
We see further increases in hedged international equities exposures



Source: BofA Global Research, APRA

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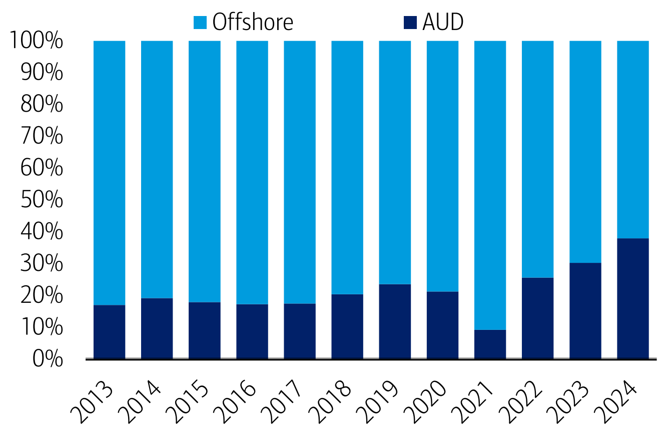
AUD demand to rise = tighter cross-currency basis swaps

Domestic AU banks maintain a significant footprint in offshore capital markets because their funding tasks have typically been too large for domestic debt markets to absorb. All else equal, banks' offshore term funding programs place widening pressure on cross-currency basis, especially at the 3y and 5y tenors, because banks hedge their foreign liabilities back to bank bill swap rates. As the superannuation fund complex expands, we expect banks to increase the size of their onshore term funding program relative to the US.

There are early signs of this dynamic at work. The proportion of domestic banks' term funding issued in AUD in 2022 & 2023 were the highest to date and have continued to rise in early 2024 (Exhibit 7, Exhibit 8). Cross-currency basis swaps show high levels of AUD demand relative to prior years (Exhibit 9). Admittedly, the RBA's liquidity injections during the pandemic have helped depress cross-currency basis but we see this dynamic persisting over the medium term as domestic appetite for fixed income grows. Superannuation demand to hedge international income streams should also place tightening pressure on cross-currency basis swaps. Given international fixed income holdings have increased in outright terms and as a proportion of total AUM (Exhibit 10), this trend is likely already placing receiving pressure on cross-currency basis swaps out to around 5y.

Exhibit 7: Ratio of domestic bank issuance onshore/ offshore
Onshore term funding programs have stepped up since the pandemic



Source: BofA Global Research, Bloomberg

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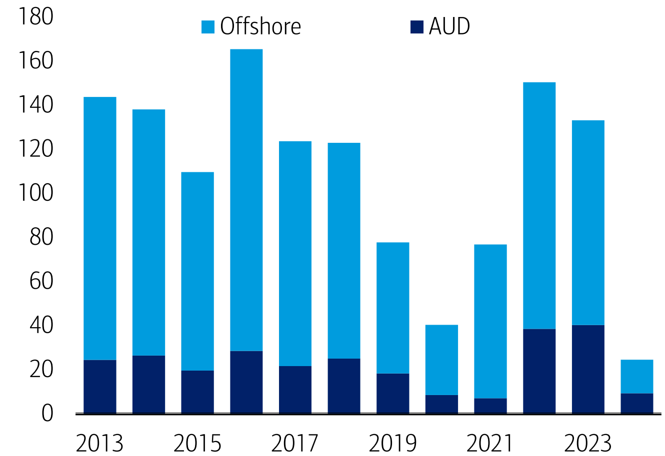
Exhibit 8: Issuance by domestic banks (AUD bn)
2022 & 2023 largest AUD slate to date



Source: BofA Global Research, Bloomberg

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Exhibit 9: 5y BBSW/SOFR basis
Structurally higher receiving pressure from super funds likely

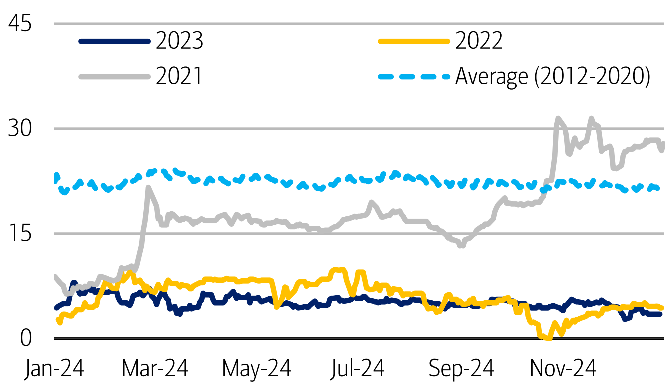

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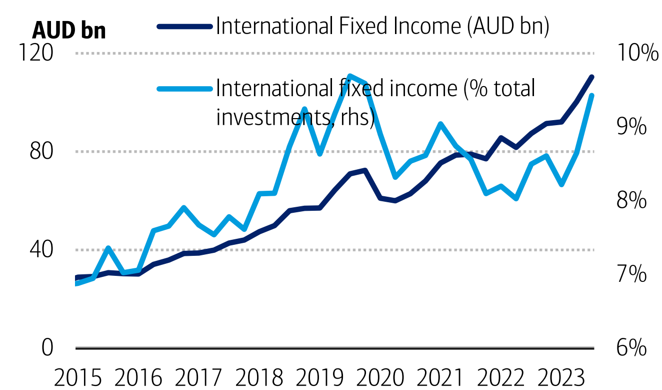
Exhibit 10: Superannuation fund international fixed income holdings
Increase in both outright terms and as proportion of total AUM



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- **Global Rates Year Ahead 2024 –** Cloudy with a chance of landing, 19 Nov 2023
- **G10 FX Year Ahead -** The year of the landing, 20 Nov 2023
- Carry me away, **Liquid Cross Border Flows**, 12 Feb 2024

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Global FX Weekly: On track 16 February 2024

Global Rates Weekly: Duration divergence 16 February 2024

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