THE FOURTH PHASE

The supranational, sovereign and agency (SSA) Kangaroo sector has been through many evolutionary stages without losing its diversification value to a range of issuers. But its latest era – of lower volume and greatly reduced prominence of benchmark-sized, mid-curve deals – has been protracted. Not all market participants are convinced of the sector's long-term health.

BY LUCY SYMONDS

In the broadest terms, the demand history of the Kangaroo market covers four phases. Each shaped the issuance patterns of the time – though all four have been supportive of SSA issuers in one way or another.

The first, starting just before the turn of the millennium, saw an emerging product driven by a European-focused bid seeking familiar high-grade names with the appealing yield of the high-rates Australian dollar environment. Australian investors became more prominent in the years leading up to the financial crisis, including a bank balance-sheet bid for repo-eligible SSA paper and asset-manager interest in both SSAs and – more commonly – international-origin credit.

As the post-crisis landscape revealed itself, Australia became something of a safe haven for global investors – especially Asian central banks with growing FX reserves to deploy. These buyers tended to have established SSA portfolios in global core currencies, and as they added Australian dollars to their reserves SSA Kangaroos were a natural inclusion.

Most recently, Asian central-bank reserve accumulation has tended to reverse as stockpiles are deployed to defend local currencies. Australian dollars, always a marginal reserve currency, have lost ground to US dollars as the US rate cycle turns.

The latest growth buyer for SSA Kangaroos has been the Japanese life-insurance sector. However, while the focus of European, Australian and Asian buyers always tended to be in the mid-part of the curve, Japanese demand is largely long-dated. The expectation of large, liquid lines also seems to be lower and deal flow has migrated to focus on a succession of small taps around the 10-year point.

Issuance dynamics in the SSA Kangaroo market have a well-established pattern. Aggregate volume has fallen for the last two full years – from A$28 billion (US$21.5 billion) in 2014, the biggest SSA year since 2010, to A$22.1 billion in 2015 and A$17.9 billion in 2016 – while deal numbers and, increasingly, volume have been driven by small, long-dated transactions. In 2016, for the first time, more than half the new SSA Kangaroo issuance came to market with tenor of eight years or longer (see chart on facing page).

The first month of the new year only reinforced the trend on deal numbers, though volume reflected the tendency for early-year issuance to be dominated by new mid-curve SSA benchmarks. In January, eight Kangaroos of seven-year tenor or less priced for total volume of A$2.8 billion, while there were 20 long-dated transactions for just A$945 million.

The first month of the year tends to be a focal point of benchmark issuance as SSAs get started on substantial funding programmes and aim to establish new pricing points in key markets. However, one day in February summed up the new trend as it might be expected to play out once the benchmark flurry subsides. On the afternoon of 10 February, no fewer than four SSA Kangaroo transactions priced, all at 9-10 year tenor and with aggregate volume of just A$170 million.

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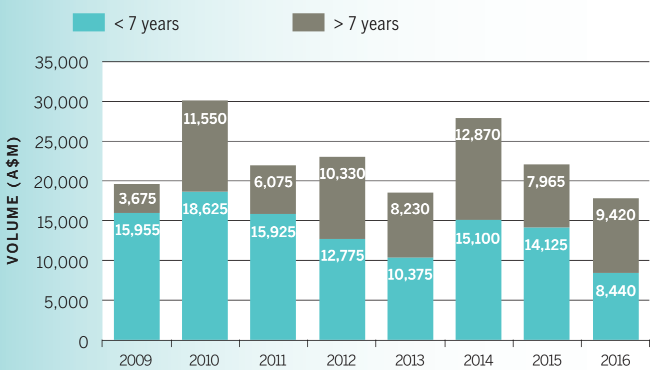
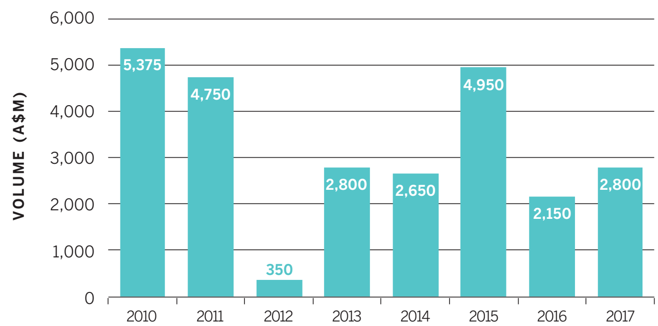
ANTHONY RUSCHPLER ASIAN DEVELOPMENT BANK

SSA KANGAROO ISSUANCE DURATION



SOURCE: KANGANEWS 9 FEBRUARY 2017

JANUARY SSA KANGAROOS, UP TO SEVEN YEAR TENOR



SOURCE: KANGANEWS 13 FEBRUARY 2017

BENCHMARK OPPORTUNITIES

The bifurcation of issuance – occasional mid-curve benchmark transactions for respectable, if lower-than-historical, volume interspersed with a steady stream of small, long-dated taps – has led some market sources to ask whether the Kangaroo market's fundamental nature, if not its value to issuers, is changing.

Asian Development Bank (ADB) has historically targeted substantial volumes in benchmark Kangaroo deals. In 2011, for instance, the supranational visited the Kangaroo market just three times but printed A$2.4 billion. In 2016, it netted A$1 billion from six deals. This is far from the most extreme case, as ADB continues to target benchmark size for its deals where possible.

ADB's Philippines-based treasury specialist, Anthony Ruschpler, says the Kangaroo market has "seen happier days" in the sense that new lines historically raised greater initial volume than has been achieved in the past two years. "The shift in market conditions has been particularly visible in long-dated deals," Ruschpler confirms. "We have seen taps mandated for as little as A$15 million to cater for specific reverse enquiries out of Japan. In fact, the long end of the curve is increasingly resembling a quasi-private placement market."

International Finance Corporation (IFC)'s Singapore-based senior financial officer, Flora Chao, says the Australian dollar mid-curve is important for IFC. But she adds: "There is still a decent pricing outcome available in the long end of the Kangaroo curve, but the mid-curve has become noticeably less competitive."

If anything, market participants appear to believe the dominant dynamics of recent years are showing signs of being even more accentuated in 2017. Although January 2017 compares reasonably well with recent years when it comes to mid-curve issuance (see chart on this page), anecdotally issuers say they are yet to be convinced that demand will be maintained outside the long end.

KfW is another large-scale SSA issuer that attempts to wait for appropriate windows into which to issue benchmark deals rather than supplying smaller deals to fulfil reverse enquiry, according to Lars Ainsley, manager, new issues at KfW Bankengruppe (KfW) in Frankfurt. But he also agrees that it is harder to issue in benchmark size nowadays.

"The depth of the market decreased sooner this year than in previous years," he adds. "In the current market environment, there are fewer issuance windows that allow for benchmark-sized transactions to be executed."

INVESTOR SUPPORT

Other than the relatively specialised interest of Japanese buyers, Kangaroo market sources acknowledge that offshore buying has scaled back significantly since the halcyon days of peak Asian central-bank interest. Global yield dynamics suggest a fully fledged rebound is unlikely in the near tearm.

Tom Irving, managing director and head of Asia syndicate at TD Securities in Singapore, suggests: "US rates are moving higher while the Australian trajectory is less certain. This makes Australia less attractive to international investors than it was when it yielded 1.5 per cent more than the US. As a result, it's unlikely that volume will return to 2014 or 2015 levels in the short term."

It is important in this context to view historical issuance volume appropriately. It may, for instance, be unfair to compare supply and demand dynamics in 2016 and 2017 with the most active periods of SSA issuance in Australian dollars. SSA flow spiked in 2010 and again in 2014, with both years seeing roughly A$30 billion pricing, but annual volume of more like A$20 billion

"We want to see domestic investors involved in buying Australian dollar product. So it is an ongoing focus for issuers to keep a regular dialogue with them."

DANIEL CHANDLER RBC CAPITAL MARKETS

LOCAL FUND MANAGERS ON *THE SSA FENCE*

The good news for supranational, sovereign and agency (SSA) Kangaroo issuers is that Australian fund managers tend to be willing to look at their deals. The bad news is that most are only sporadically active.

Darren Langer, senior portfolio manager at Nikko Asset Management (Nikko) in Sydney, reveals that the firm participates in the SSA Kangaroo market but opportunistically and generally only for its more liquid portfolios. Relative value – to semi-government bonds, government bonds and swap – is a critical consideration. SSAs are not a core holding for Nikko.

"All SSAs issue in Australian dollars when it is cost-effective for them to do so. But this does not necessarily mean it is the most opportune time for an investor to buy," Langer argues. "There may be multiple issuers chasing the same execution window and there tends to be very little opportunity for new issues to perform well. We prefer issuers that have a well-defined yield curve and a regular issuance pattern as we favour liquidity over any excess spread that may exist for smaller, less regular issuers."

Other investors point to their preference for the more predictable issuance patterns of the Australian Office of Financial Management and Australian semi-government names. The lower predictability of SSA flows makes trading difficult. The ongoing supply of small taps only exacerbates this concern according to Tim van Klaveren, managing director and senior portfolio manager at UBS Asset Management in Sydney.

"It comes down to transparency," he tells *KangaNews*. "If issuers come to the market every time pricing on their bonds tightens it is difficult for investors to manoeuvre their portfolios to trade relative value. As a result, investors like ourselves look to buy five-year paper because we know the longer end of the curve will be dominated by the Japanese insurance bid – which is catered to with small private-placement type deals."

QIC's Brisbane-based head of credit research and strategy, Phil Miall, also reveals that the proliferation of smaller, long-dated Kangaroo deals does not suit his firm's mandates. "We generally prefer the larger SSA issuers and we would like to see them coming to market with meaningfully sized benchmark trades. So for now we are concentrating on the semi-government space in lieu of Kangaroo SSA bonds."

"We prefer issuers that have a well-defined yield curve and a regular issuance pattern as we favour liquidity over any excess spread that may exist for smaller, less regular issuers."

DARREN LANGER NIKKO ASSET MANAGEMENT

has been more common since the financial crisis. Last year in particular required Japanese long-dated demand to maintain a total in this range, but the market has always flexed to demand.

Intermediaries argue that when volume spikes it tends to be driven by relatively short-term surges in demand from specific investor bases. Although the Australian market has historically succeeded in finding new buyers to supplement old groups as their accumulation phases wane, the SSA sector retains a functional base level of demand even in the absence of a supernormal flow.

"In retrospect, 2012-14 was an opportune time for global investors to get involved in the Kangaroo market," suggests Rod Everitt, Sydney-based head of Australian dollar syndicate at Deutsche Bank. "Central banks in particular were divesting core currencies and reallocating funds into other currencies like Australian dollars. In addition, the yield structure looked significantly more attractive than it is now and SSA funding programmes were increasing globally. It was the perfect storm of supply-and-demand dynamics."

DOMESTIC SHORTFALL

However, while the vagaries of various international bids are inevitably the product of factors beyond the control of the Australian market, one area where some Kangaroo market participants are prepared to acknowledge a degree of frustration is the consistently limited level of interest displayed by domestic investors.

Leading up to February 2011, Australian bank liquid-asset books were, anecdotally, unusually active as SSA buyers. However, this bid evaporated almost overnight when expectations that SSA paper would be included in Australia's interpretation of high-quality liquid assets (HQLAs) under Basel III were confounded.

SSAs now find themselves caught between two stools when it comes to the Australian bank bid. Without HQLA status, SSAs do not get the favoured treatment in bank books afforded to local sovereign and state issuers. SSAs are included in the committed liquidity facilities (CLFs) banks use to make up the shortfall in local HQLA supply, but they tend to be lower yielding than other CLF assets. Banks would rather securitise their own mortgage books for CLF purposes than buy SSAs.

As for Australian fund managers, taken as a whole this audience has always given SSAs a tough reception. The preferred asset tends to be major-major bank paper, with its mix of creditworthiness, familiarity and liquidity. Australian fund managers say they participate in the SSA sector, but rarely as a core holding (see box on this page).

Greater local engagement would be a major breakthrough for issuers, as investor diversification is a key goal of being involved in a noncore market like Australia in the first place. Ruschpler explains: "The long-end of the Kangaroo market gives us access to a Japanese investor base that has particular requirements for Australian dollars. However, it is true that we would like to see more domestic participation in our mid-curve transactions as these are the accounts that aren't necessarily as active elsewhere."

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> **TOM IRVING** TD SECURITIES

Daniel Chandler, director, debt capital markets at RBC Capital Markets in Sydney, says local demand has tended to be a marginal call of late. He tells *KangaNews*: "We want to see domestic investors involved in buying Australian dollar product, so it is an ongoing focus for issuers to keep a regular dialogue with them. So far in 2017, we have tended to see some domestic investors being a little more price sensitive, and more broadly there have been clearly defined price breaks for volume."

Issuers say they do see domestic participation when overall conditions are supportive of substantial, mid-curve deals. For instance, Andrea Dore, lead financial officer at World Bank in Washington, reveals that Australian demand for the supranational has remained steady over the last year.

World Bank completed a A$550 million, five-year trade in January last year and printed A$600 million of five-year notes in January this year. Both transactions saw close to 30 investors, which Dore says represents good investor diversity. She adds that 35 per cent of the 2016 book was bought by Australian investors while half the slightly larger deal priced by World Bank this year went to local accounts.

MARKET RELEVANCE

Despite the apparent challenges and the increasingly bifurcated nature of the Kangaroo market, issuers are quick to point out that they remain committed to Australian dollar issuance in Kangaroo format.

Ainsley says KfW's ongoing desire for a well-diversified funding programme means Australia remains important. In fact, Australian dollars were one of the agency's top-four funding currencies in 2016 and KfW continues to strive for both volume and market development. "We aim to have a strong presence in the Australian dollar market. We are currently looking at all prospective markets for issuing a green bond. If demand arises in the Australian dollar space, we are prepared to return to market with a green bond," Ainsley says.

Others point out that while benchmark issuance windows may come around less frequently than at the peak of the Kangaroo market it is still more than possible to secure good outcomes in Australian dollars.

Rentenbank's Frankfurt-based treasurer, Stefan Goebel, says: "Our first Australian dollar transaction for 2017 encountered strong demand at an attractive pricing level during a time of significant competing supply. This trade proved once again that the Kangaroo market is a valuable contribution to our strategic goal of diversifying our investor base and provides access to investors we don't see in other currencies."

Some issuers see no problem with serving both the mid-curve and long-dated demand pools as and when they provide opportunities – and say adopting a flexible issuance strategy to meet the specifics of each is the most sensible approach in the current environment. Inter-American Development Bank (IADB) is one such borrower.

Laura Fan, head of funding at IADB in Washington, explains: "Typically we size our deals to investor demand, and if there is interest for longer-dated issuance we will attempt to accommodate it. The market favoured long-dated issuance in the back end of 2016 and continues to focus on the long end in 2017. However, a dearth of supply in the mid-curve resulted in pent-up investor demand which contributed to issuance opportunities in the mid-part of the curve in January."

GROWING THE BID

Everitt adds that an obvious positive factor for the contemporary Kangaroo market is the solid baseline of natural demand for the product. He suggests that although investors will always compare where Australian dollar product is trading with offshore options, most buyers come to market if they are specifically looking for assets in Australian dollars or have Australian money to put to work.

Other market users say the very idea of Australian dollars as a less popular funding destination is not quite accurate. "The amount of conversations we have had with borrowers about our view on the Reserve Bank of Australia, the basis swap and other Australian fundamentals is increasing," reveals Oliver Holt, head of Australian dollar syndicate at Nomura in Singapore. "In fact, it would be fair to say we are having more conversations about the Australian market now than we have in the last three or four years."

ANZ's Sydney-based director, debt syndicate, Harald Eikeland, argues that the next source of SSA issuance growth is likely to be domestic investors. He comments: "There appears to be less demand for offshore currencies more generally given the overall strength of the US dollar market. Local demand has always been present for SSA paper, but we have to account for the decrease in balance-sheet buying." •