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AOFM Investor Insights

Australian Government

Australian Office of Financial Management

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Introduction

This edition of Investor Insights covers the role of Treasury Notes in the AOFM's portfolio.

The AOFM issues three different instruments, collectively known as Australian Government Securities (AGS): Treasury Bonds (TBs), Treasury Indexed Bonds (TIBs), and Treasury Notes (T-Notes). T-Notes do not pay coupons; instead investors pay a discount to the face value repaid at maturity.

Maturities typically range from three to six months but can be as long as 12 months.

The AOFM manages the Australian Government's cash balances to ensure that it can always meet its financial obligations. T-Notes and TBs can have a role in cash management, however T-Notes are a more flexible cash management tool. Table 1 highlights some of the key features and differences between them.

Table 1: Comparison of Treasury Notes and Treasury Bonds.

Treasury Notes

- **Funding strategy:** Are issued from the Cash Management Portfolio (CMP) for short-term financing.
- **Issuance:** Volume and rates of issuance can vary significantly over the year.
- **Tenor:** Usually issued with tenors of three to six months with multiple maturities in a year.
- **Risk:** Can reduce refinancing risks by spreading maturities over multiple dates.
- **Liquidity:** The market is primarily a 'buy and hold' market, meaning lower secondary turnover for Treasury Notes relative to Treasury Bonds.
- **Demand:** Are used by investors seeking a secure, short-term investment and may represent a 'safe haven' for investors in times of market stress.

Treasury Bonds

- **Funding strategy**: Are issued from the Long-Term Debt Portfolio (LTDP).
- **Issuance**: Usually issued at a steady weekly rate.
- **Tenor**: Have tenors up to 30 years with one or two maturities in a year.
- **Risk**: Long maturity dates reduce refinancing risks.
- **Liquidity**: Issuance is concentrated into a few maturity dates per year, which enhances secondary market liquidity.
- **Demand**: Are attractive to a wide range of investors with differing risk and return objectives.

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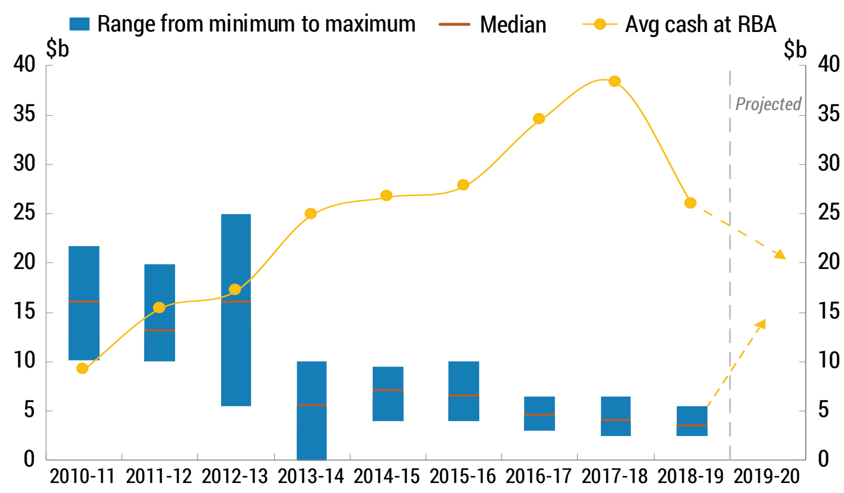
How do Treasury Notes fit into the overall funding strategy?

T-Notes form part of the CMP and are used to 'smooth' peaks and troughs in the cash cycle which arise because of the mismatch in the timing of receipts and outlays. In terms of total AGS outstanding T-Notes have represented only about one to two per cent on average at any point in time over the last six years. CMP decisions are typically considered separately to those regarding the LTDP. For example, the AOFM's current long issuance bias for TBs is independent of the T-Notes issuance strategy.

The AOFM maintains a holding of liquid assets to accommodate unforeseen periods of adverse impacts on in-flows to the CMP. These assets would cover circumstances where the AOFM was not able to raise sufficient funds (for reasons of market access) to meet the Government's short-term funding requirements. However, holding precautionary liquid assets incurs a cost because the interest earned on the assets in question is typically lower than the cost of funding them.

Chart 1 illustrates how T-Notes have been used to manage peaks and troughs in the cash cycle. From 2013-14 the AOFM reduced the issuance of T-Notes and funded higher cash balances with additional TB issuance. This period coincided with increasingly elevated issuance programs to fund budget deficits and maturing TBs.

Chart 1: AOFM use of Treasury Notes



Source: AOFM

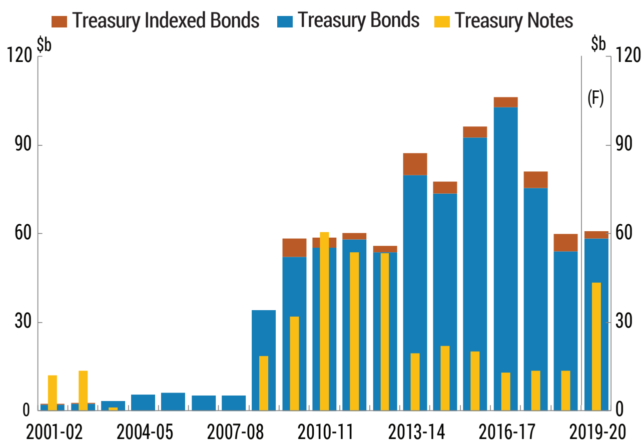
Why is the AOFM increasing Treasury Note issuance?

Lower funding tasks imply reduced financing risk. A long-term issuance bias and the TB buyback program assist by reducing the size of bond lines as they approach maturity. Issuing T-Notes for cash management will allow for lower total AGS outstanding on average compared to using TB issuance to fund precautionary liquid assets. This is because the AOFM can reduce issuance of T-Notes at times in the cash cycle when cash balances are high because of revenue collection or lower outlays.

The amount of T-Notes on issue at any time as a proportion of total AGS outstanding will still remain small. Therefore, the impact of additional T-Notes will be minor both in terms of refinancing risk and the overall duration of the combined CMP and LTDP.

Chart 2 shows historic and forecast issuance of AGS with a return to a more active use of T-Notes in 2019-20. Gross T-Note issuance of around $40 billion is planned for the year with a projected median market size of about $14 billion and peaks at times exceeding $20 billion. However, the actual amount issued may differ to forecasts because the precise timing of within-year cash flows are unknown, although the broad pattern planned for 2019-20 is likely to be consistent over the next few years.

Chart 2: Gross Issuance of Australian Government Securities



Source: AOFM

How does the AOFM issue Treasury Notes?

T-Notes are issued by competitive tender, the same as TBs and TIBs. In recent years the AOFM has issued T-Notes fortnightly for market maintenance purposes rather than for cash management needs.

Returning to a more active T-Notes program will involve weekly tenders of at least $500 million. Larger tender sizes may occur at times, especially in the lead up to bond maturities or significant cash outlays. The longest tenors will still be around six months but larger issuance will allow for a greater number of maturities at any point in time. Individual line sizes can be expected to be larger than in recent years, but will usually be no more than around $10 billion.

Investor demand for Treasury Notes

T-Notes are used by investors seeking a short-term, low-risk investment and can be an effective way to manage their cash profiles. Experience suggests that domestic and offshore investors comprising a mix of fund managers, insurers, government agencies, central banks, and bank balance sheets will be the most active participants.

Table 2 shows that T-Notes comprise a relatively small proportion of domestically issued short-term securities. T-Notes form part of an asset class that includes bank paper and short-dated bonds (including AGS). For many investors, over-the-counter derivatives such as forward rate agreements, short-dated swaps, and reverse repos can be used both as an investment and for managing interest rate risk.

Table 2: Short-term debt securities outstanding – domestically issued as at 30 June 2019

	$b	% of total
Securities shorter than 12 months when issued		
Issued by:		
Banks and other non-government issuers	240	67%
Semi-government (as commercial paper)	21	6%
AOFM (as T-Notes)	3	1%
Long-term securities with less than 12 months to maturity		
Issued by:		
Semi-government (as bonds)	42	12%
AOFM (TBs & TIBs)	35	10%
Banks and other non-government issuers	16	4%
Total	**356**	

Source: RBA, AOFM, Bloomberg AusBond Composite 0-1 Yr Index

Although the amount of T-Notes and short-dated TBs on issue would still comprise a relatively small proportion of total short-dated securities, higher rates of T-Note issuance could benefit many investors and may assist with increasing secondary market activity.

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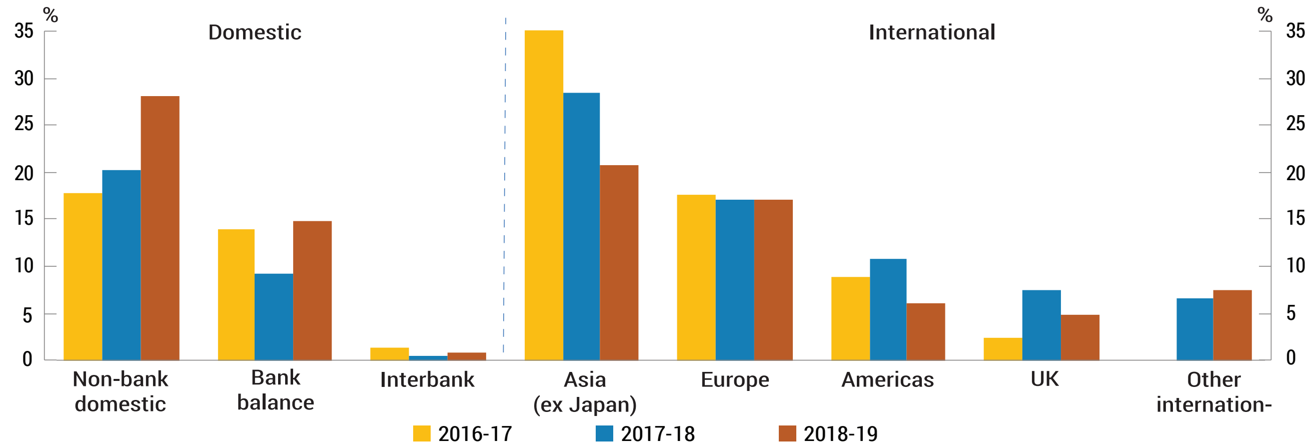
Chart 3 shows secondary market turnover collected from T-Notes secondary market makers over the past three years. More than half of secondary market turnover is offshore. The relatively small amount of interbank turnover suggests that most investors in T-Notes, hold them to maturity.

Chart 3: Treasury Notes secondary market turnover



Source: AOFM

Domestic investors

Non-bank domestic turnover increased in the last year, from around 20 per cent to be just under 30 per cent of total turnover. This segment includes fund managers and superannuation funds. Although many domestic fund managers benchmark their portfolio to a credit benchmark, such as three-month BBSW, T-Notes can still play a role in these portfolios.

Bank balance sheets include small and medium-sized banks that may hold T-Notes to satisfy APRA high quality liquid assets (HQLA) requirements. Because of the relatively small amounts of T-Notes on issue, T-Notes have been used for HQLA more by smaller banks. However, as the amount on issue increases T-Notes could become a more attractive investment for larger banks.

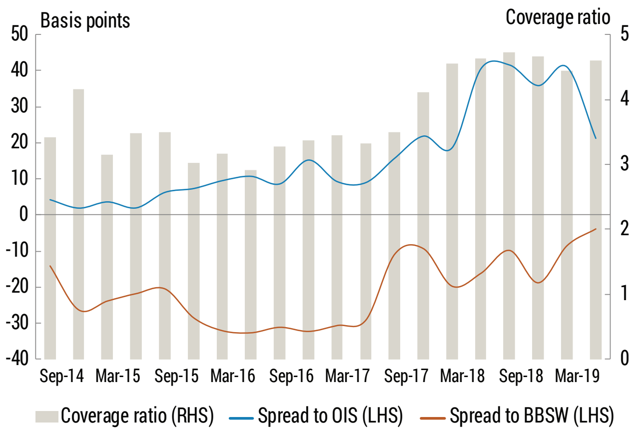
Offshore investors

Offshore investors include official money investors such as central banks requiring short-term, low-risk investments. For many offshore investors such as insurers and asset managers, T-Notes provide a credit risk-free way to take a view on the Australian dollar exchange rate while receiving a yield which is higher than for many global short-term money markets, including Europe and Japan. Although still the largest offshore category, turnover in Asia (ex-Japan) decreased from around 35 per cent in 2016-17 to 20 per cent in 2018-19. This decrease may have been driven by a reduction in holdings from a small number of official money investors.

Treasury Notes primary market

Investor demand for T-Notes can be observed through the performance of tenders. Chart 4 shows that T-Note tenders are generally well-supported by intermediaries with an average coverage ratio of 4.6 times in 2018-19. Issue yields for T-Notes tend to move in line with the expected level of the RBA cash rate. However, from around 2015 the spread between the overnight indexed swap rate (OIS) and issuance yields on T-Notes started to widen and continued to increase in 2017. At the same time spreads to BBSW began to contract, although yields have remained below BBSW on average. Recently there are signs that short-term funding pressures are starting to ease, which has led to a contraction in issuance spreads to OIS.

Chart 4: Average quarterly Treasury Note issuance spreads and coverage ratio

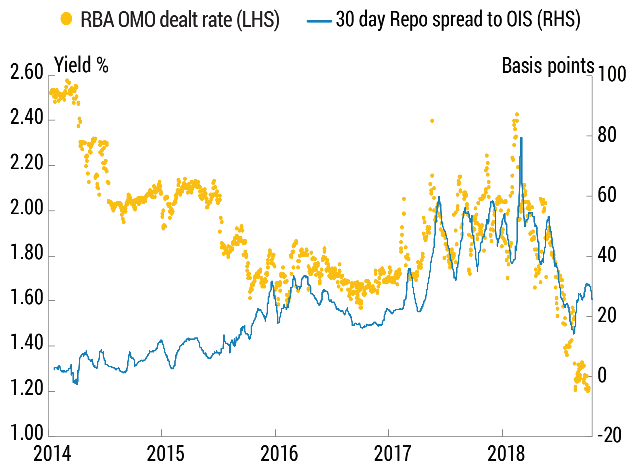


Source: AOFM, Refinitiv

For many investors, the level at which they can obtain short-term funds impacts their demand for short-term assets, including T-Notes. In recent years a feature of the AGS market has been the emergence of non-residents as borrowers of cash in return for lending securities (including AGS). At the same, time prudential regulations have limited the extent to which bank balance sheets can lend cash to meet higher demand.

Chart 5 shows that increased demand for cash has been associated with an increase in the repo rate at which the RBA transacts through its open market operations (OMO). The RBA repo rate has a strong influence on funding levels in the Australian market.

Chart 5: RBA OMO repo spreads



Source: RBA, AOFM, Refinitiv

Some institutions (for example superannuation funds and some banks) are beginning to lend cash through reverse repo as an alternative short-term investment. An increase in reverse repo activity would be beneficial to the market through lowering funding cost and this could also flow through to T-Notes.

Looking forward

Improving fiscal outlooks and smaller bond issuance programs has led the AOFM to return to a more active T-Notes program. T-Notes are used to manage the Government's cash balances and are a more flexible funding tool than TBs for managing the within-year peaks and troughs in the cash cycle. Issuing T-Notes to fund short-term asset balances is usually less costly than using TBs, although having very large amounts of T-Notes outstanding could attract elevated refinancing risk in limited circumstances where financial markets were extremely volatile. Future issuance plans will depend on several factors, including changes to the pattern of the cash cycle, changes in the fiscal position and funding outlook, as well as investor preferences for T-Notes compared to other investments.

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