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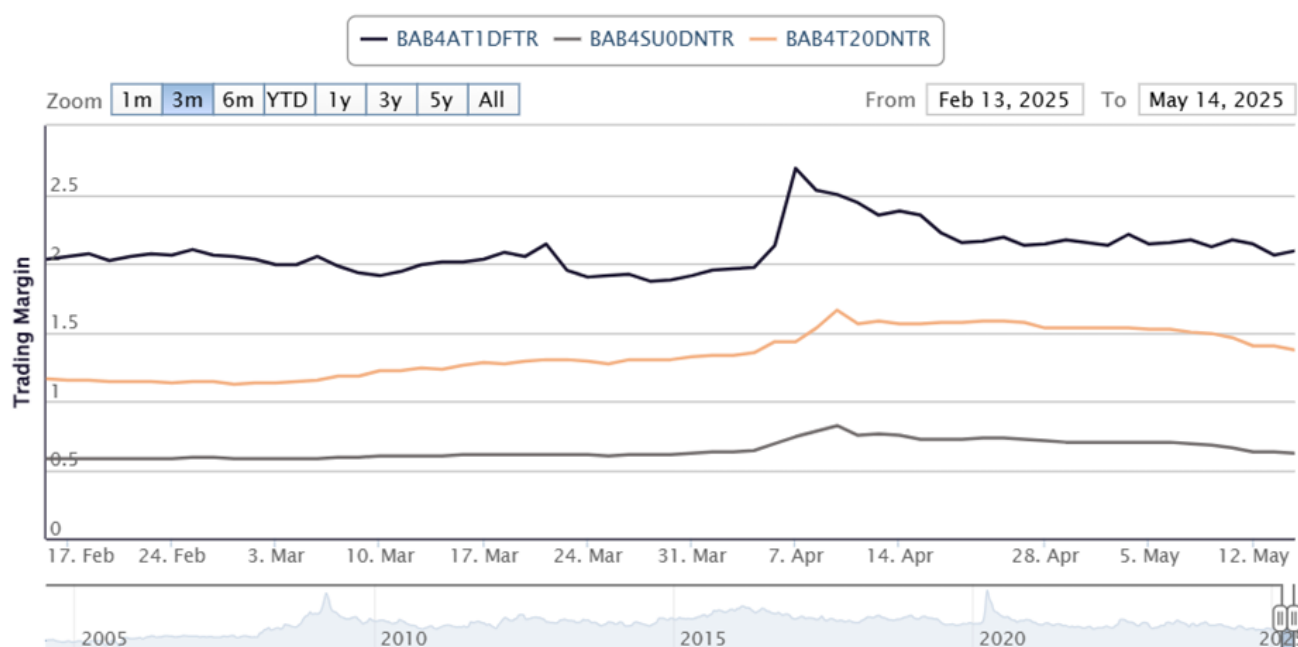
Alternative to hybrids

By James Verschoor

Since our last update, Tier 2 (T2) spreads have tightened meaningfully, though they have widened relative to Additional Tier 1 (AT1) instruments. Market sentiment improved following the announcement of the 90-day US-China trade agreement on the 13th, along with greater clarity from the Federal Reserve around its interest rate policy. This resolution of uncertainty has paved the way for a busy period in the primary market, with notable T2 issues from MyState and QBE, as well as a AAA-rated medium-term note (MTN) from Airservices Australia.

According to BondAdviser's Tier 1 and Tier 2 indexes (see Figure 1), since 5 May, AT1 securities have moved 72 basis points wider relative to T2. Over this period, T2 spreads tightened by 15bps while AT1 spreads only tightened by 5bps.

Figure 1:



Source: bondadviser

The major bank AT1 curve has flattened, particularly at the longer end, driven by buying interest in names like ANZ and CBA. T2 spreads have compressed more broadly, with Westpac's curve showing particularly strong performance.

Meanwhile, senior unsecured spreads—after experiencing some volatility in early April—have now returned to their previous levels, trading around 62-63bps above swap. As a result, T2 premiums are now trading at approximately 75bps, down from 82bps on 5 May.

In the corporate hybrid space, securities are trading in a range of +180 to +200bps above BBSW, offering yield-to-call levels exceeding 5.5%. Investment-grade issuers such as Scentre Group, TransGrid, and AusNet continue to provide opportunities. Like bank hybrids, corporate hybrids are long-dated, callable, and subordinated to senior debt. However, they differ in that corporate hybrids are not convertible to equity, reducing certain risks associated with bank hybrid structures.

Given that many major bank hybrids in the middle of the capital structure are trading at yield-to-call levels between 5.4% and 5.9%, corporate hybrids may offer attractive relative value, particularly for investors holding bank AT1s at the tighter end of the curve.

Please see below for a selection of T2 corporate bond opportunities currently available.

Issuer	Sector	Rank	Cpn Type	Cpn Formula	S&P, Moodys, Fitch Rating	Call Date	Yield	Margin (bps)	Running Yield
SCENTRE GROUP TRST 1	Financial	Subordinated	FIXED	5.900%	BBB+, Baa1, NR	30-Sep-31	5.780%	191.9	5.863%
SCENTRE GROUP TRST 1	Financial	Subordinated	FLOATING	BBSW3M+2.000%	BBB+, Baa1, NR	30-Sep-31	5.713%	186.4	6.080%
AMPOL LTD	Energy	Subordinated	FLOATING	BBSW3M+2.500%	NR, Baa2, NR	11-Dec-29	5.558%	191.3	6.460%
AUSNET SERVICES HOLDINGS	Utilities	Subordinated	FIXED	6.187%	BBB-, Baa3, NR	12-Nov-30	5.650%	188.7	6.036%
AUSNET SERVICES HOLDINGS	Utilities	Subordinated	FLOATING	BBSW3M+2.250%	BBB-, Baa3, NR	12-Nov-30	5.625%	187.7	5.946%
NSW ELECTRICITY NETWORKS	Utilities	Subordinated	FIXED	6.277%	NR, Baa3, NR	11-Mar-33	6.092%	209.4	6.207%
NSW ELECTRICITY NETWORKS	Utilities	Subordinated	FLOATING	BBSW3M+2.050%	NR, Baa3, NR	11-Mar-30	5.548%	187.6	6.117%

Credit Update: Australian Major Banks (CBA AU, WSTP, ANZ, NAB)

S&P confirmed that it would maintain ratings on all the major banks even after AT1s are phased out. This is despite its calculations showing ANZ and NAB falling below the 10% threshold on their Risk Adjusted Capital (RAC) metric. This is because S&P believes that the AT1 phase out will not negatively reflect on the fundamentals or the core strengths of the banks. We don't think the market was pricing in any downgrades, but this is still marginally positive.

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