# Schroder Fixed Income

Quarterly Investment Option Update

30 September 2021

## Aim and Strategy

To obtain exposure to a range of domestic and international fixed income assets with the objective of outperforming the Bloomberg AusBond Composite 0+Yr Index, whilst delivering stable absolute returns over time. The option adopts a Core-Plus investment approach whereby a core portfolio comprising of Australian investment grade bonds (including government, semi-government, supranational and corporate bonds) is complemented by investments in a diverse range of global and domestic fixed income securities. The targeted result is a defensive strategy which is broadly diversified with low correlation to equity markets.

## Investment Option Performance

To view the latest investment performances for each product please visit amp.com.au/performance

## Investment Option Overview

| | |
|---|---|
| **Investment Category** | Fixed Interest |
| **Suggested Investment timeframe** | 3 years |
| **Relative risk rating** | 4 / Medium |
| **Investment style** | Core |
| **Manager style** | Single Manager |

| Asset Allocation | Benchmark (%) | Actual (%) |
|---|---|---|
| Aust. Investment Grade | 100% | 75.5% |
| Cash & Equivalents | 0% | 5.4% |
| Global Investment Grade | 0% | 3.0% |
| Australian High Yield | 0% | 8.8% |
| Global High Yield | 0% | 7.4% |

| Sector Allocation | % |
|---|---|
| Government | 29.6 |
| Semi-Government | 17.1 |
| Supranational/Sovereigns | 5.2 |
| Corporates | 32.5 |
| Subordinated | 5.0 |
| Collateralised | 5.7 |

| Quality Allocation | % |
|---|---|
| AAA | 35.3 |
| AA | 18.1 |
| A | 8.6 |
| BBB | 27.2 |
| Below BBB | 4.2 |
| Not Rated | 0.9 |

| Top Holdings | % |
|---|---|
| AUSTRALIA (COMMONWEALTH OF) 0.25 21-NOV-2024 Reg-S | 5.3 |
| NEW SOUTH WALES TREASURY CORPORATI GOVTGUAR 3.0 20-MAR-2028 Reg-S | 3.8 |
| AUSTRALIA (COMMONWEALTH OF) 2.75 21-NOV-2028 Reg-S | 3.5 |
| AUSTRALIA (COMMONWEALTH OF) 2.25 21-MAY-2028 Reg-S | 2.8 |
| AUSTRALIA (COMMONWEALTH OF) 2.75 21-MAY-2041 Reg-S | 2.1 |
| NEW SOUTH WALES TREASURY CORPORATI 2.0 08-MAR-2033 | 1.9 |
| AUSTRALIA (COMMONWEALTH OF) 4.75 21-APR-2027 Reg-S | 1.7 |
| AUSTRALIA (COMMONWEALTH OF) 2.75 21-NOV-2029 Reg-S | 1.6 |
| TREASURY CORPORATION OF VICTORIA 1.5 10-SEP-2031 | 1.5 |
| AUSTRALIA (COMMONWEALTH OF) 2.75 21-NOV-2027 Reg-S | 1.4 |

## Investment Option Commentary

The Schroder Fixed Income Option delivered a negative relative return in the September quarter (before fees). Performance continues to be very strong over the year.

Key positioning changes included taking profits on the fund's yield curve flattening positions, both in Australia and the US. More recently, the manager has shifted to a shorter-than-benchmark duration position and realigned the portfolio to benefit from steeper yield curves. The manager expects interest rates will rise for longer dated securities as the market prepares for higher growth and inflation. The manager is also focused on diversifying interest rate risk across countries to capture expected central bank divergence. The manager expects central banks to vary in their pace of reducing liquidity support by tapering of bond purchases and eventually shifting rates higher.

## Market Commentary

Concerns around slower growth, higher inflation, an unwind of central bank stimulus and ongoing concerns around Evergrande and the potential for broader contagion across the Chinese real estate and financials sectors, resulted in a broad sell off in both equities and bonds during September. The updated “dot plots” from the US Federal Reserve (Fed) minutes revealing their expected interest rate outlook was more hawkish than the market had initially anticipated, with the dots indicating one rate hike by the end of 2022, and further rate hikes that would bring the Fed Funds rate up to 1.75% by the end of 2024. Meanwhile, the outlined plan to taper central bank asset purchases also worried markets, with tapering expected to begin in November and for asset purchases to potentially finish by mid next year. With inflation lingering at higher levels and the outlook still uncertain, while growth estimates are being revised lower, the prospect of a stagflationary environment is weighing on sentiment across global markets.

Developed market (DM) equities fell by 3.7% in local currency terms during September, while the Australian market fared a little better but still dropped by 1.9% for the month. Emerging markets (EM), were the laggard, falling by 4.0% in US dollar (USD) terms. At a sector level, higher oil prices saw energy stocks be the standout performer both in Australia and globally, while materials was the weakest performing sector. Despite the pullback through September, over the quarter, Australian equities still delivered a 1.7% return, while DM equities returned 0.6% in local currency terms. EM equities were the clear underperformer, falling by 8% in USD terms over the quarter. This hawkish sentiment from the Fed and some other central banks such as the Bank of England, along with lingering concerns around higher inflation, resulted in bond yields moving higher during September. The US 10 year yield rose by 0.18% to end the month at 1.5%, while Australian 10 year yields increased by 0.34% to also finish at 1.5%. Spreads were moderately wider in Australian investment grade credit and EM sovereign debt, while in global investment grade and high yield, credit spreads were generally flat. Over the quarter, longer end bond yields made a round trip, falling in July and August, before rising in September to finish roughly where they started across most markets. Higher US yields and a broad sell off in risk markets resulted in safe haven currencies like the US dollar and Japanese yen outperforming the Australian dollar, the Euro and the British pound.

## Outlook

There is a lot of worry in global financial markets at the moment. Bond yields have backed up sharply, equities are gyrating and the energy crunch is intensifying. Natural gas prices have soared in Europe and a severe power shortage has shut down a big part of China’s manufacturing activity – both will weigh on GDP growth. With global forces slowing growth while increasing inflation, policymakers are struggling to find a path forward. Central bankers almost everywhere are facing the same bad dream: a mix of slowing growth and inflationary supply shocks that together threaten stagflation. Ironically, some central banks may be happy to see higher inflation expectations after years of fighting deflation.

Long-dated Treasury bond yields have risen close to 40bps from early August. The trigger for the bond selloff has been more hawkish commentary from the US Federal Reserve (US Fed) and the Bank of England (BOE). The US Fed is likely to start to taper its asset purchases in November and the BOE looks set to hike interest rates late this year. Central banks have been trying to distinguish between the tapering of bond purchases and interest rate hikes, but the market is interpreting these recent moves as the beginning of monetary tightening, bringing forward expectations of the first US rate hike to the end of 2022. The punchbowl of easy monetary policy is being pulled away, whether it be in the form of tapering or higher rates – and markets are naturally concerned.

Global central banks face a delicate balancing act. Tighten too soon, and they could impair the recovery; tighten too late, and inflation could become entrenched. Responding to supply-side shocks with tighter monetary policy is extremely dangerous. The price spikes today are mostly caused by supply disruptions rather than excess demand. In fact, there are few signs of excess demand anywhere in the world. Supply disruptions, bottlenecks and long delays are akin to war-like conditions that cannot be cured by either monetary or fiscal policy. But keep in mind that relative price shocks are often self-correcting. For example, lumber prices have fallen 70% from the highs in May as high prices have destroyed demand and brought back more supply. Iron ore prices have recently collapsed as Chinese steel mills have been forced to cut back production because of power shortages and the huge jump in iron ore prices prior earlier in the year. Central banks understand they are dealing with a different type of inflation and have so far resisted acting, but the transitory shock is lasting longer than expected. The problem is supply constraints could take another year to resolve, allowing inflation expectations to rise.

In Australia, the RBA has time on its side – inflation is well below target and wages growth is weak. The RBA recently confirmed its current policy settings and reiterated that the conditions for policy tightening (actual inflation sustainably within the 2-3% range) will not be met before 2024. Given this dovish stance, the main directional driver of Australian interest rates will be the speed at which economic re-opening occurs and the growth impulse that creates. The RBA's optimism is in line with the broader consensus and should, along with their slow reduction in bond purchases, continue to exert upward pressure on longer maturity bond yields. Beyond that, the trajectory of global yields will be the major directional influence for Australian interest rates. For these reasons, the fund holds a 0.1yr short position versus the target.

Credit spread volatility remains very low in Australia while offshore markets have been more closely linked to rising concerns around inflation and fears that a potential default by China's Evergrande Group could impact stability of the Chinese banking system and property market. The manager's position in high quality Australian investment grade corporates which have been largely insulated from the offshore volatility is expected to provide adequate yield spread compensation over government bonds.

It remains an uncertain environment with a lot of mixed signals and market influences. The economic data and policy developments have never been so important for the future direction of markets. The fund is ensuring there is the liquidity to be nimble, making use of relative value as an alpha driver, and attempting to make the most of security selection opportunities.

## Availability

| Product name | APIR |
|---|---|

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|---|---|
| AMP Flexible Lifetime Super | AMP1288AU |
| AMP Flexible Super - Retirement account | AMP1376AU |
| AMP Flexible Super - Super account | AMP1505AU |
| CustomSuper | AMP1288AU |
| Flexible Lifetime - Allocated Pension | AMP1295AU |
| Flexible Lifetime Investment (Series 2)** | AMP2040AU |
| SignatureSuper | AMP1302AU |
| SignatureSuper Allocated Pension | AMP1309AU |

**Closed to new and existing investors

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