Schroder Fixed Income

Quarterly Investment Option Update

30 September 2022

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	5/ Medium to high
Investment style	Core
Manager style	Single Manager

Asset Allocation	Benchmark (%)	Actual (%)
Aust. Investment Grade	100%	80.2%
Cash & Equivalents	0%	16.3%
Global Investment Grade	0%	-4.5%
Australian High Yield	0%	6.3%
Global High Yield	0%	1.7%

Sector Allocation	%
Government	19.7%
Semi-Government	25.7%
Supranational/Sovereigns	12.4%
Corporates	30.6%
Subordinated	2.2%
Collateralised	4.2%

Quality Allocation	%
AAA	33.4%
AA	27.5%
A	8.8%
BBB	20.3%
Below BBB	2.7%
Not Rated	2.1%

Top Holdings	%
NEW SOUTH WALES TREASURY CORPORATI GOVTGUAR 3.0 20-MAR-2028 Reg-S	4.6%
AUSTRALIA (COMMONWEALTH OF) 2.25 21-MAY-2028 Reg-S	2.6%
AUSTRALIA (COMMONWEALTH OF) 2.75 21-NOV-2029 Reg-S	2.5%
QUEENSLAND TREASURY CORPORATION NONDMUNI 1.75 21-AUG-2031 Dual 144a|Reg-S	2.3%
TREASURY CORP OF VICTORIA NONDMUNI 5.5 17-NOV-2026	1.9%
AUSTRALIA (COMMONWEALTH OF) 4.75 21-APR-2027 Reg-S	1.9%
WESTERN AUSTRALIAN TREASURY CORP 1.75 22-OCT-2031	1.7%
AUSTRALIA (COMMONWEALTH OF) 3.25 21-JUN-2039 Reg-S	1.7%
AUSTRALIA (COMMONWEALTH OF) 3.0 20-SEP-2025 Reg-S	1.6%
TREASURY CORPORATION OF VICTORIA 1.5 10-SEP-2031	1.6

Investment Option Commentary

Thus far, 2022 has been one of the toughest years for financial markets in decades, with bonds and equities declining in unison. The September quarter was very volatile, with July generating strong returns across most asset classes, followed by weakness in August and September. Interest rate volatility reached new cycle highs with global bond yields moving higher and risk sentiment deteriorating, reflected in weaker equity markets and wider credit spreads. The moves came as investors grew increasingly concerned about a recession, thanks to a combination of hawkish central banks, major disruptions to Europe's energy supply, and some serious market turmoil in late-September that was connected with the UK government's fiscal policy. While global bond yields moved higher over August and September, Australian bond yields haven't breached the highs from mid-June, driving outperformance of the Australian bond market for the September quarter relative to its global peers.

The Bloomberg Ausbond Composite index returned -0.64%, and the portfolio underperformed this over the quarter. Schroder added value versus index via interest rates across duration and curve positions, as yields increased and yield curves flattened. However, their credit positioning detracted from performance as Australian investment grade bonds performed poorly. Their credit derivative hedges provided a partial offset, insulating the physical holdings, resulting in negative performance relative to the benchmark. Inflation linked bonds underperformed over the quarter, detracting modestly from performance.

Schroder is managing their duration exposure around a neutral position, with a bias to add more duration as they become more confident inflation is slowing. Their credit positioning remains defensive, but similarly Schroder is patiently waiting for opportunities to become more constructive before they increase credit exposure. Fixed income is offering much better absolute value following the repricing, and good value relative to some other assets, given the challenging cyclical outlook.

Market Commentary

Central banks reiterated their hawkish stance on the policy outlook, putting bond markets under continued pressure. The US Fed and European Central Bank (ECB) both increased their policy rates by 0.75% in September, while the RBA also increased the local cash rate by 0.5% through the month. Looking forward, implied pricing of policy rates into 2023 suggests further official rate increases, with the Fed Funds rate expected to rise above 4.5%, the local cash rate expected to reach almost 4% and policy rates in Europe expected to move above 3%. In the UK, the announcement of new unfunded tax cuts resulted in a sharp sell off in UK government bonds leading to concerns about a potential collapse in UK pension funds. This eventually forced the Bank of England (BoE) to intervene through pausing QT and temporarily purchasing long dated UK government bonds. Australian 10 year bond yields increased by 0.29% through September to close at 3.89%, while US 10 year yields they increased significantly more – rising by 0.64% over the month to finish at 3.83%. German 10 year bond yields also jumped sharply, increasing by 0.57% pushing them above 2%, while Japan remains the exception, with the Bank of Japan's yield curve control policy keeping yields across the curve anchored. Credit spreads continued to widen over the month across all sectors, most notably in high yield and in emerging market debt. Over the quarter, front end yields in the US and Germany saw the biggest jumps, increasing by 1.3% and 1.1% respectively, while credit spreads were broadly unchanged across most markets.

Outlook

With the magnitude of drawdowns this year, a legitimate question to ask is whether the worst is behind us? A huge restoration of value across fixed income markets has now presented some great opportunities, even though macro volatility is high. The drivers for a more significant process of normalisation of volatility from here are:

- A convincing confirmation of a downward trajectory on inflation, stronger than the type of evidence seen recently and that has led to a couple of false starts on the pricing of peak inflation. This is more likely to happen as negative base effects start to impact significantly on inflation, particularly in Q1 2023.
- The crystallisation of the US Fed terminal cash rate view and a smaller level of uncertainty around it. In the current context, Schroder expect to see this collapse of uncertainty only around the last couple of official rate increases of the cycle.
- A shift in the dynamic of equities and credit markets, whereby earnings expectations become a more significant driver, as higher interest rates have dominated the recent bearish dynamic for risky assets. This again likely requires a crystallisation of Fed terminal rate expectations, along with pressure from deteriorating fundamentals on earnings expectations.

While Schroder expect these conditions to start to come together over the next quarter, the manager believe the process is likely to be gradual as fundamentals deteriorate. The timeline for meeting this condition is likely to be backloaded into late 2022/early 2023. As these conditions are met, this will allow the reduced correlation between government bonds and riskier assets to become more beneficial for portfolio diversification.

Strategic assessments:

It seems probable that the post-GFC economic and market environments have ended, however not as intended. The RBA and other central banks were caught flat-footed by an inflation surge and have been forced to abandon stimulatory policy well before strong growth could help reduce the debt burden resulting from COVID stimulus. It remains unclear what the next regime will be, however in Schroder's assessment:

- Economies and markets are undergoing a dramatic readjustment. Economies are adjusting to tight labour markets and energy supply disruption, while markets are adjusting to significantly tighter central bank policy. Fiscal policy also needs an overhaul; financed by monetary policy keeping rates low, and designed to sustain consumption rather than stimulate investment, it has become too short-sighted.
- Increased uncertainty about medium-term growth and inflation outcomes, impact of climate-related policies, geopolitical and demographic risks, should all result in investors demanding higher risk premia from fixed income and equity assets.
- To a degree this is priced. Schroder's 3-year expected return forecasts on Australian bonds is indicating returns of 4% to 6% p.a.
- Bond-equity correlations are subject to a positive shift should inflation stay elevated, causing a rethink on traditional portfolio construction techniques. Some alternative asset 'safe harbours' may prove illusory.

Implications for markets

- Investors are now demanding higher risk premia, given the increased uncertainty about medium term growth and inflation outcomes, and climate-related, geopolitical, and demographic risks. Psychologically, it means adjusting to a world where the central banks are no longer as friendly and market supportive.
- Over much of the last 12 years, with inflation undershooting targets, central banks were often happy to push for easy policy when conditions looked tough. It was common to hear some variation of TINA (There Is No Alternative), the idea that one needed to be long equities and credit because cash offered so little. These tighter policy rates are now scrambling that mindset and with inflation elevated across the developed world, that dynamic has changed.
- The last 12 months of losses are now continuing to help normalise long-term returns, which for many years – even decades – have been well above their long-term trends. What makes this current period worse historically is that Schroder is now noticing deep losses in nominal terms which, for many countries, has never previously happened over a sustained period outside of wars or defaults. This decade stands out versus all others and although it is still young, the main difference is the comparatively low starting point for yields.
- Rising yields and widening credit spreads have caused a lot of pain but with the restoring of value across most of the fixed income universe, investors can now anticipate several higher yielding, low volatility alternatives compared to some other asset classes.

Positioning:

The cyclical picture is becoming more supportive of bonds and valuations which are much more appealing than at the start of the year. The strategic value of fixed income has also improved with higher yields and a potentially more uncertain, higher volatility environment.

- With central banks currently tightening very aggressively, and as it's too early to accurately gauge the impact of their actions on both inflation and growth, the manager is taking a patient approach to building aggregate duration.
- A pivot by central banks remains a way off in Schroder's view as policy makers deliver on what is priced into markets. Schroder shortened duration in August and September to position for higher terminal rates as inflation remains sticky and labour demand tight.
- In general, Schroder continue to expect yield curves to stay flat as rates are hiked. However, it is plausible that front end pricing is high enough for this cycle. Schroder continue to look for opportunities to reduce the flattening exposure by closing their short duration positions in the front-end of yield curves.
- Credit faces a very uncomfortable macro mix, with downside growth and profitability risk adding to liquidity headwinds. However, spreads have moved significantly wider already, and while the manager believe riskier credit is still vulnerable, higher quality investment grade corporates offer good carry, especially on an all-in-yield basis. Schroder have recently started to increase exposure to Australian investment grade corporates that are offering yields greater than 5%.
- Schroder are being even more patient in adding to credit than to duration. The manager will become more

constructive as recession risks are increasingly priced.

Macro volatility is likely to persist as we move into late cycle and a peak in official rates is formed. Despite the volatility Schroder is optimistic that better fixed income returns are ahead, and that fixed income will retain strong strategic value to portfolios. Schroder's portfolios are well placed to deliver on both, and the manager is carefully becoming more constructive in their portfolio settings.

Availability

Product name	APIR
Flexible Lifetime Investment (Series 2)**	AMP2040AU

**Closed to new and existing investors

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