Schroder Real Return

Quarterly Investment Option Update

30 September 2022

Aim and Strategy

To deliver an investment return of 4-5% pa before fees above Australian inflation over rolling three-year periods. Inflation is defined as the RBA's Trimmed Mean, as published by the Australian Bureau of Statistics. The portfolio invests across a broad array of asset classes including equity, alternatives and debt to ensure the portfolio is truly diversified in both an economic and asset class sense. The portfolio employs an objective-based asset allocation framework in which both asset market risk premia and, consequently, the asset allocations of the portfolio are constantly reviewed. As risk premia (and thereby expected returns) change, so too will the asset allocation of the portfolio (and sometimes significantly). The portfolio will reflect those assets that in combination are most closely aligned with the delivery of the objective. The investment manager believes that in effect it's not the asset classes that are important but the likely characteristics of the return. The approach utilises a combination of Schroder's longer-term return estimates together with their shorter-term value, cycle and liquidity framework

Investment Option Overview

Sector Allocation	%
Australian Equity	7.28%
Global Equity	15.50%
Absolute Return	-2.14%
High Yielding Credit	11.18%
Insurance Linked Securities	5.59%
Asian Credit	4.23%
Emerging Market Bond	5.10%
Australian Fixed Income	12.84%
Global Fixed Income	3.36%
Rate Strategies	2.45%
Cash & Cash Equivalents	34.62%

Investment Option Performance

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

Investment Category	Multi Sector (Specialist)
Suggested Investment timeframe	5 years
Relative risk rating	5 / Medium to high
Investment style	Active
Manager style	Single Manager

Investment Option Commentary

Largest contributors

The primary contributor to returns through September was foreign currency, adding almost 1% to returns over the month, driven by the strength of the US dollar (USD). Beyond this, the portfolio's private debt and real estate debt allocations, and the relative value trades contributed marginally to returns over the month. Over the quarter, the positive contributors were similar, with currency being the primary source of positive returns, adding 0.8% over the 3rd quarter, while private debt and real estate debt were smaller contributors.

Largest detractors

Equities was the primary detractor during September, having a -1.5% impact on returns, with -0.5% from Australian equities and -1.0% from global equities. The continued move higher in bond yields, meant that duration was another key detractor, with a -0.9% impact on returns over the month. Over the quarter the key detractors were similar, with equities detracting -1.0% from returns, primarily through global equities, while duration detracted by -0.8%.

Market Commentary

Equities

Equity markets sold off through September, reacting to a higher than expected US inflation data at both the core and headline level. The ongoing hawkish messaging from central banks, notably the US Fed, indicating that they would continue to tighten policy into a growth slow-down in order to control inflation, resulted in weaker sentiment across risk assets. The selloff in equities has improved valuations across all regions, with the S&P 500 now trading at a forward P/E of 15.5x. Despite the improvement in valuations, market multiples in the US have on average bottomed out at around 11.5x through previous bear markets. Global equities fell by -8.4% in local currency terms over September, while Australian equities fell by -6.2%. Emerging market equities underperformed, falling by -11.7% in US dollar terms. Over the quarter, Australian equities delivered a positive return of 0.4%, while global equities declined by -4.5%.

While our base case continues to remain negative on the outlook for equities, Schroder does recognise the improvement in equity valuations, which has subsequently resulted in improved expected returns over a three-year horizon. As a result, Schroder did increase the portfolio's equity exposure by around 5% in the last week of September, taking the total equity allocation to 23%. The overall positioning of the fund remains defensive, but Schroder has added a moderate amount of risk back into the portfolio.

Fixed Income

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 pensions 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.

With the increase in bond yields, valuations have improved for government bonds and are close to fair value in some markets. Schroder added 0.5 years of duration back into the portfolio through Australia and the US in the last week of September. This takes portfolio duration up to 2.25 years, the highest level since March 2020. Schroder also increased the portfolio's investment grade credit exposure by 1% over the month by closing out

the US investment grade credit derivative protection that was in place.

Currencies

The USD continued to climb over the month, as the selloff in both risk assets and bonds, continued to drive safe haven flows into the dollar, pushing the US dollar index up by 3.1% for the month, and 7.1% for the quarter. Through September, the Euro fell below parity once again against the US dollar, while the British pound fell to an all-time low, dipping below $1.04 against the USD, before recovering some of its losses in the final few days of the month. The Japanese yen (JPY) also continued to depreciate despite the efforts of the finance ministry, which purchased US$19.7 billion worth of yen over the month. The Australian dollar was also hampered by the strength of the USD, falling by approximately 7%. The portfolio's overall currency exposure remains broadly unchanged with over 20% foreign currency risk in aggregate. The primary exposures remain in defensive currencies – the USD, followed by the JPY.

Outlook

The broad-based sell-off in bond and equity markets regained momentum in September. The numbers make grim reading, with the S&P 500's -9.3% decline taking its decline this year to -23.9%, and the sell-off in US government bonds delivering a return on US 10-year treasuries of -4.7% (-15.7% year-to-date). Against this, the USD remains strong, rising +3.1% in September in trade-weighted terms (or 16.8% year-to-date). Commodities (GSCI) declined -8.7% in the month, led by oil, but reflecting generally softer prices across the board as global demand weakened. While the weakness in equities is significant, Schroder believes it's not out of the 'norm'. For bonds though, the bear market has now wiped out the cumulative returns from the last 10 years from 10-year government bonds, the worst performance since the 1950s.

The Schroder Real Return Fund returned -1.3% (pre fees) with our extreme defensive positioning including our lowest equity weighting since inception (amid the GFC) mitigating the impact, but unable to fully insulate returns from the breadth and depth of September's asset price weakness.

The key driver of September's weakness was inflation, and the realignment of interest rates to the reality of stubbornly higher inflation dashed hopes that central banks would respond to market weakness and signal a more dovish rate outlook, perhaps even halting tightening altogether. While it is unlikely Central Banks will reverse course, emerging signs of system stress suggest that the pace of tightening may moderate.

Despite the breadth and extent of falls so far, the unravelling of markets has been relatively orderly. The key exception to this though has been the UK. The British pound (GBP) was battered, with the UK Gilt market collapsing after the UK government unveiled a budget with significant unfunded tax cuts (fiscal stimulus). At the same time, the Bank of England (BoE) is tightening policy to battle rampant cost of living pressure in the economy. With currency and money markets rioting, the BoE had little choice but to intervene to halt the risk to the UK financial system and the spill-over into the global economy. This highlights the fragility of the global financial system in this environment, and that there are clearly pain points that will force Central Banks to intervene. However, Schroder do not read this as a signal that other central banks (like the US Federal Reserve or the European Central Bank) are poised to reverse course on monetary tightening, albeit a moderation in the pace of tightening is probable. If anything, it likely highlights the need that policy settings are aligned with economic realities for long run financial stability.

Data in September provided strong evidence of this anticipated reality. US inflation continued to surprise on the upside, with US headline inflation of 8.3% year-on-year (y/y). More concerning, core CPI rose to 6.3% y/y, suggesting that inflation is not just an oil story but indeed becoming more broad-based. To put this into perspective, the trimmed mean inflation rate (which strips out the largest increases/decreases) rose to a new high of 7.2% – well above the 5.1% reached at the peak of the 80-90s. This places even more pressure on the Fed to continue a hawkish policy stance, despite signs of continuing economic weakness and rising recession risk.

Our recession dashboard now has 60% of its components flashing red. Excluding the GFC Recession of 08-09, this is the highest reading in over three decades. This places risk assets in a precarious situation as central banks around the world are forced into a corner of continuing to tighten policy into a slowdown. Liquidity is also likely to be under pressure in the coming months as US quantitative tightening steps up to US$95bn per month, almost double the maximum US$50bn per month seen in the 2018 liquidity crisis.

While recession fears and liquidity tightening remain key negatives for risk assets, the positive is that valuations

are seemingly improving in response to price weakness. For example, the US S&P 500 is trading on a forward PE of around 15x, which is not out of line with historical market bottoms given the level of inflation and interest rates being priced by the market. However, this does assume that earnings can continue to deliver going forward, which Schroder thinks unlikely. Earnings revisions have turned negative, and margins appear to be rolling over. Schroder believes further weakness in company margins (reflecting higher input costs including wages and weaker demand) will lead to more aggressive earnings downgrades over coming months. While this might not become evident until the September or December earnings quarter, shock downgrades like the recent announcement from FedEx may accelerate this process in the coming months. Schroder believes a ratcheting down of earnings in the face of tighter monetary policy settings will lead to the next move lower in equity markets. While caution is required, Schroder expects markets to remain volatile, which does present possible opportunities to modify our positioning. While our overall equity weight remains low, Schroder did add 5% to our exposure in the last week of September, as Schroder believes that in the medium-term context, current levels present a reasonable point to start cautiously re-investing.

Fuelled by dislocation in the UK and stubbornly high inflation, September proved another extremely volatile month for government bonds. 10-year bond yields in Australia pushed briefly above 4% and close to 4% in the US before easing back towards month end, helped by BoE intervention in the Gilt market. While Schroder does expect more tightening (and ongoing hawkishness), the pace of tightening (size of increases and the time between them) will likely moderate from here, as central banks start to assess the impact of the accumulated rise to date on growth and inflation, and emerging signs of system distress. While markets sometimes forget, central bankers are acutely aware of the lags between rate rises and their impact (albeit this doesn’t mean they won’t still over-tighten as their track record isn’t great).

Any duration has been a drag on total returns this year and Schroder clearly started to add duration too early this year. That said, Schroder did lean into the weakness of late September by buying predominately longer-dated bonds in the US and Australia. This was done in an effort to take advantage of potentially higher yields on offer and the perceived likelihood that market focus will switch towards recession risk from inflation risk in coming months, shifting the balance of risk to lower yields. Schroder thinks it likely that, if the next phase of equity weakness is driven by earnings (and recession), bonds are likely to be a more effective hedge than they have been so far this year.

Schroder acutely believe that markets will likely turn well before the uncertainty around economic outcomes clears. As Schroder has noted above, Schroder aims to lean into market weakness and are starting to re-invest cash at higher yields, wider spreads, and improved equity valuations, as Schroder intends to establish an improved base for future returns. The caveat is that current volatility may not reflect a mid-cycle correction where ‘buy-the-dip’ is the right strategy. Schroder believe that Schroder is in the midst of a more classic business cycle. Pro-cyclical policy has likely led to overheating, asset price inflation and the need to tighten. The extent of the over-stimulus and its reflection in inflation means recession may be a likely outworking of policy tightening. This will take time to play out and there will be casualties which are yet unknown (albeit Schroder is starting to see more sign of stress – like the UK and potentially the odd investment bank). Markets will likely be volatile for a while, so while Schroder is seeking to prudently deploy cash, Schroder remains inherently cautious. An earnings recession could well mean another 10-20% decline in equity prices – that’s possibly the real buying opportunity for exceptional medium-term returns.

Availability

Product Name	APIR Code
SignatureSuper*	AMP1858AU
SignatureSuper - Allocated Pension*	AMP1862AU

* Closed to new investors

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