Schroder Real Return

Quarterly Investment Option Update

31 December 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 Performance

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

Investment Option Overview

Investment Category	Multi Sector (Specialist)
Suggested Investment timeframe	3 years
Relative risk rating	4 / Medium to high
Investment style	Active
Manager style	Single Manager

Sector Allocation	%
Australian Equity	7.56%
Global Equity	15.34%
Absolute Return	-1.96%
High Yielding Credit	14.94%
Insurance Linked Securities	5.38%
Asian Credit	4.06%
Emerging Market Bond	5.10%
Australian Fixed Income	14.56%
Global Fixed Income	9.78%
Rate Strategies	2.58%
Cash & Cash Equivalents	22.66%

Investment Option Commentary

Largest contributors

Through December, foreign currency (primarily driven by the strength of the Japanese yen), emerging market corporate debt, insurance linked securities, equity put options and duration overlays each added approximately 0.1% to returns over the month. The portfolio's relative value strategy and higher yielding Australian credit allocation were secondary contributors to returns over the month. Over the quarter, equities added 2.1% to returns, with 0.8% from Australian equities and 1.3% from global equities. Insurance linked securities added 0.3% to returns over the quarter, while global investment grade credit added a further 0.2%.

Largest detractors

The primary detractor from returns over December was equities, which had a -0.8% impact. Within equities, global equities was the primary detractor, detracting by over -0.7%, while Australian equities only had a relatively minor impact. Duration was another major detractor from returns, dragging down returns by -0.5% through December, primarily driven by the weakness in Australian bonds. Over the quarter, foreign currency was the primary detractor, having a -0.3% impact on returns. This was primarily driven by the weakness of the USD over the quarter.

Market Commentary

Equities

Concerns around the growth and earnings outlook for 2023, as well as ongoing hawkish rhetoric from central banks globally, which drove bond yields higher, resulted in equity markets selling off over the month. Despite these concerns, consensus 2023 earnings growth expectations from analysts remain positive for now across most major markets, though they had been progressively revised lower over the second half of 2022. In December, most equity markets had negative returns, with China and Hong Kong being notable exceptions, where the relaxation of China's zero COVID policy improved growth prospects in both economies. Global equities fell by -5.1% over the month, while Australian equities outperformed with a return of -3.2% in December. Emerging markets returned -1.4% over the month. In spite of the pullback in December, equities produced a positive quarter, with global equities returning 7.4% in local currency terms, Australian equities returned 9.4%, while emerging markets had a return of 9.7% in USD terms.

After a strong rally in November, Schroder downgraded Schroder's view on equities. The months ahead will likely continue to see inflation easing and corporate earnings slowing but not crashing, which could support equity returns in the short term. Therefore, Schroder's preferred strategy is to remain invested but to build convexity into portfolios. At the start of December Schroder added further put option protection to the portfolio, buying 10% notional 5% out of the money put options, bringing Schroder's total exposure to 15%. Schroder's direct exposure to equities remains around 29%, but Schroder's delta adjusted exposure (when taking into account the put options) has dropped to 23% as the market has fallen towards the option strikes. If the market rallies from here, Schroder will continue to participate given Schroder's direct exposure, but if the market falls even further, Schroder's delta adjusted position will fall to 15%, protecting portfolios from a larger equity market adjustment.

Fixed Income

Both the US Federal Reserve (Fed) and European Central Bank (ECB) delivered a 50 bp increase to official rates in December, while the RBA raised rates by 25 bp. While bond yields moved higher globally, the moves were more pronounced in Europe as the ECB's messaging was more hawkish than the market had anticipated, with ECB President Lagarde indicating that rates would still need to increase significantly in 2023 in order to curb inflation. In the US, inflation continued to ease and came in below expectations, with headline inflation moving to 7.1% on a year on year basis, while core inflation slowed to 6%. Meanwhile, the Bank of Japan (BoJ) adjusted its yield curve control policy to allow 10-year Japanese bond yields to move up to 0.5%. In December, Australian 10-year bond yields moved 0.52% higher to finish at 4.05%, while US 10-year yields increased by 0.27% to end the year at 3.87%. German 10-year bond yields increased by 0.64%, while Japanese yields also increased by 0.17%, after being capped at 0.25% for an extended period. Over the month investment grade credit and emerging market debt spreads both tightened moderately, while high yield spreads moved wider.

Through the fourth quarter, bond yields moved moderately higher, with the most notable change in German yields which moved 0.46% higher for longer dated bonds, and over 1.0% higher for shorter maturity bonds. Credit spreads and emerging market debt spreads also tightened somewhat over the quarter, with the exception of Australian investment grade spreads, which were flat over the quarter.

Yields have compressed from their highs as inflation rolls over, but central banks continue to reiterate their hawkish stance and their priority on winning the fight against inflation. Schroder have therefore reduced Schroder's duration position by 0.25yrs. Schroder continue to focus on the front end of the curve in the US and expect curves to steepen, as either a recession leads to rates being cut earlier than currently priced or stickier than expected inflation requires higher risk premia for longer dated bonds. Schroder have also reduced Schroder's allocation to global high yield corporates by 2% as spreads have tightened circa 100-200bp since Schroder added exposure in October and therefore offer less compelling value at this stage.

Currencies

In December, the US dollar (USD) weakened moderately against most currencies, with the Dollar index down -2.3%. The most notable move was in the Japanese yen (JPY), which continued its run of recent strength, and appreciated by 5.0% against the USD, driven by a relaxation of the BoJ's yield curve control policy and potential that the next BoJ governor may adopt a more hawkish approach to monetary policy in comparison to the current governor, Kuroda.

While the USD is expensive on most valuation metrics, it's being supported tactically by both the hawkish Fed and broader global uncertainty. While Schroder do think longer term it will weaken, it remains an effective risk-off hedge and this mitigates any negative USD view based on valuations. Schroder remain positive on the JPY given its cheapness, and the fact that it is typically a good risk-off hedge. The recent widening of the yield curve control by the BoJ has ignited a rally in the JPY over the past month.

Outlook

2022 was a tough year for investors. Inflation reared its ugly head and a decade of very loose monetary policy came to an abrupt end. Global equities fell by 16% in local terms and the global aggregate bond index fell 12% over the year. A standard US 60/40 portfolio delivered -17% over the year, which is the worst return since the 1930's outside of the 2008 financial crisis. When asset return correlations go to one, there are very few places to hide other than cash, which while delivering positive nominal returns, still offered abysmal returns after inflation this year. Many investors will be happy to see the end of 2022 and are hoping for a brighter 2023.

Assessing Schroder's predictions from 2021

It's always very difficult to predict what will happen in the year ahead. None of us have a crystal ball and investors are notoriously terrible at predicting regime shifts. To be honest, even the best macro investors make their money by adjusting their positions as conditions change, as opposed to having supreme soothsayer abilities. That is why it's always a little cringeworthy to re-examine commentary from a year ago and read what Schroder were thinking about the world back then. The below summarises Schroder's views from 12 months ago:

- Central banks will need to begin responding to rising inflation. The mismatch between nominal growth outcomes and policy settings is extreme and this gap will inevitably close.
- Both global growth and profit growth will moderate in 2022, not dramatically (Schroder are not forecasting recession) but slowdown from the heady pace of the 're-opening' of the global economy. Schroder think the risks here are probably to the downside.
- Valuations remain optimistic in key risk assets (like US equities). Against a less accommodative policy and growth / profit backdrop, it is highly likely that these valuations will be tested in 2022 – particularly on the back of any negative surprise or disappointment in profits.
- While cash rates remain at or around zero in major markets, sovereign bond yields have moved modestly higher, reflecting the tussle between rising inflation and high debt loads that likely limit the extent to which yields can move. While Schroder still believe that the higher yields (and low fixed income returns) are likely in 2022, this may ebb and flow as economic variability and pressure from markets oscillates.
- It's very likely that 2022 will be a more challenging year for investors than 2021.

I'm pleased to see Schroder were not too far off, although it's clear to see Schroder did not anticipate the magnitude of the problem (largely as a result of much higher inflation) that was ahead of us 12 months ago. Schroder can all agree though that 2022 was definitely more challenging for investors than 2021. Central banks did adjust their extremely loose policy to combat inflation and the mismatch between nominal growth rates, but Schroder did not predict headline inflation would print a high of 9.1% in the US. The US went into a technical recession in the first half of 2022, but ultimately economic and profit growth did very well in 2022. While Schroder were probably too early on Schroder's slowing growth thesis, equity markets fell substantially as valuations were tested, but mainly through higher inflation and bond yields rather than corporate earnings rolling over.

As Schroder started 2022, Schroder's stretched valuation views were then supported by Schroder's weakening cyclical and liquidity indicators. Very early in the year Schroder's recession models started flashing red so a recession became Schroder's base case early on. Liquidity was being drained at levels not seen since pre-GFC as the Fed started aggressively hiking official rates while also embarking on quantitative tightening at double the maximum pace achieved in 2018. The new Taylor rule was suggesting a US terminal rate of 5%, which was definitely not being priced by the market at that time. Schroder therefore cut risk substantially, halving Schroder's equity weight from a high of almost 40% in October 2021 to less than 20% by the end of the first quarter of 2022. Schroder's cash position reached a high of 45% as Schroder looked to insulate the portfolio from volatility and drawdowns.

Goodbye 2022, hello 2023

Where inflation settles will be the biggest driver of asset class returns next year. Schroder do believe that inflation has peaked and Schroder now have confirmation that the Fed has 'pivoted' away from consecutively hiking 75bps, but it is still too early to know whether inflation will fall back down to 2% or settle at a higher plateau. The market has priced in a more realistic peak Fed Funds rate of 5% in 2023, but assumes rate cuts before the year is over, which is inconsistent with most recent Fed messaging, so probably only likely if something breaks. Schroder believe that either a recession will lead to demand destruction, allowing the Fed to truly pivot and cut rates, or inflation will remain more persistent and rates will have to stay higher for longer. Worse still, the economy could fall into a recession before inflation rolls over, causing the Fed to tighten into a downturn, exacerbating the slowdown in activity.

While Schroder may have been too early on Schroder's recession call, Schroder still believe the risk of a recession is higher than the market is pricing for 2023. Earnings expectations for US equities has fallen to 4% growth for 2023, but still remains optimistic given continued margin compression and weakening demand. CEO confidence for the economy six months ahead has reached an all-time low since the measure began in 1987. Top down earnings models using global purchasing managers indices (PMIs) suggest a 15% contraction in earnings, whereas non-PMI leading indicators suggest a 20% fall, both of which are consistent with a typical business cycle recession. Consumers remain well supported, but their cash buffers and propensity to spend will likely come under pressure in the first half of 2023. With the Fed focusing on moving the unemployment rate higher, spending is likely to curtail, which will have implications for profits. If the economy continues to expand at a moderate pace and consumer consumption remains strong, then the peak Fed funds rate can move even higher than 5%, which would further de-rate equities.

Equities have rallied from the September low alongside the fall in bond yields as inflation has peaked, but have not priced in a fall in earnings, either if demand falls or if rates stay elevated. Schroder believe equities can fall circa 15-20% from here into 2023, however it will not be a straight line down and timing will be important. Schroder added to Schroder's equity allocation aggressively at the end of September as Schroder saw improved valuations, stretched negative positioning and sentiment, inflation rolling over and anticipated economic and earnings growth holding up into year end. But after a strong rally, valuations have deteriorated and the extreme negative positioning has mostly washed out, so equities look far less attractive heading into 2023.

With inflation rolling over sovereign yields have fallen, leading to strong performance for duration in the last two months. While Schroder do not believe duration has yet fully priced a recession, it has become a very heavy trade, with the most recent BAML global fund manager survey showing long bond positions are 2.7 standard deviations above average. While Schroder believe duration will be the place to hide when a recession hits, it's less certain to protect us if inflation remains sticky. Schroder believe the Fed remains hawkish and hopes to keep cash rates at or above 5% for the entirety of 2023 and not cut rates, which the market is currently pricing. With hawkish surprises from the ECB, BoE and even most recently the BoJ, Schroder do not believe current valuations in duration are sufficient to compensate for the globally coordinated hawkish stance of central banks.

It is often dangerous to extrapolate current views into the future, but Schroder do not believe the first half of 2023 will offer any reprieve to investors. Equity valuations likely have to re-rate even lower and bonds may remain positively correlated until Schroder can put the inflation genie back in the bottle. Schroder believe 2023 will be another volatile year, with both equities and yields oscillating in wide ranges. Eventually, duration will be the place to be as the economy rolls into a recession and then it will be time to rotate into equities once central banks start cutting and valuations are more attractive. The good news is that 2023 is likely to be the year where risk premia is reset, which will set the stage for strong forward returns. In the meantime, active asset allocation and stock selection will likely be the main driver of returns.

Availability

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

* Closed to new investors

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