AB Dynamic Global Fixed Income

Quarterly Investment Option Update

31-December-2017

Availability

Product name	APIR
AMP Flexible Super – Choice (Retirement)	AMP2022AU
AMP Flexible Super – Choice (Super)	AMP2027AU
CustomSuper	AMP1997AU
Flexible Lifetime – Allocated Pension	AMP2002AU
Flexible Lifetime – Super	AMP1997AU
SignatureSuper	AMP2007AU
SignatureSuper – Allocated Pension	AMP2014AU
Flexible Lifetime Investment (Series 2)	AMP2036AU

Investment Option Performance

Investment performances are subject to product fees and where relevant tax as outlined in the product PDS. Therefore investment performance may differ between products. In addition, activity on your account such as contributions and deductions will also impact the investment performance specific to you. To view the latest investment performances for each product, please visit **www.amp.com.au**. You can also view the last investment performance specific to you by visiting your My Portfolio account.

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Overview

Aim & Strategy: The strategy is designed for investors with higher risk tolerances and who want income returns exceeding Australian bank bill rates over the long term by investing in global debt or fixed income securities. It implements a global, multi-sector strategy investing in a broad range of debt securities. The strategy may hold corporate bonds, government bonds, asset-backed securities, mortgage-backed securities, and bank loans located anywhere in the world, including emerging countries. Up to 40% of the strategy's assets may be high risk and rated below investment grade. The strategy intends to hedge its foreign currency exposures to Australian dollars. Derivatives may be used to manage risk exposures, invest cash and gain or reduce investment exposures. Derivatives will not be used for leveraging or gearing purposes.

Investment category: Global bonds

Suggested Investment Timeframe: 5 years

Standard Risk Measure: 3/ Low to medium

Investment category: Specialist

Asset Allocation	Actual (%)	Range (%)
Australian Fixed Interest	9.60	0-100
International Fixed Interest	86.8	0-100
Cash	3.60	0-5

Holdings

Industry Exposure	%
Investment Grade Corporates	33.83
Global Sovereign	38.31
Emerging Markets	15.75
Securitised	3.25
High Yield Credits	5.27
Other (incl. Derivatives & Currency)	3.60

Regional Exposure	%
Europe (excl. Great Britain)	21.57
North America	36.05
Other (incl. Supranationals)	9.57
Great Britain	8.03
Latin America	7.75
Japan	5.73
Australia & New Zealand	11.30

Top Ten Securities	%
AUSTRALIA BOND 5.75% 07/15/2022	8.12
CANADA BOND 1.5% 06/01/2023	4.07
US TREASURY INFL .125% 04/15/2021	2.93
POLAND BOND 4% 10/25/2023	2.02
US TREASURY NOTE 2.25% 08/15/2027	1.94
US TREASURY NOTE 2.25% 02/15/2027	1.75
MEXICO BOND 10% 12/05/2024	1.53
BRAZIL BOND 10% 01/01/2021	1.45
JAPAN I/L #22 INFX .1% 03/10/2027	1.39
JAPAN I/L #21 INFX .1% 03/10/2026	1.34

Market Commentary

Global growth was solid in 2017, and the Federal Reserve continued to drain liquidity—slowly—from the system. But contrary to expectations, bond yields remained low and financial conditions got easier. AB think that will change over the course of 2018. Central bank action will vary across regions, though, creating opportunities for fixed-income investors.

2017 was supposed to be the year that would shake up the status quo of modest growth, tepid inflation and low bond yields. It didn't live up to expectations. Benchmark government bond yields remained low despite improving global growth, and long-term US Treasury yields fell faster than shorter-dated ones rose, causing the yield curve to flatten. Equities and high-yield bonds, on the other hand, continued to rise, and US and European credit spreads continued to tighten. Overall, financial conditions were substantially easier at the end of the year than they had been at the beginning.

The US yield curve has worried some investors, who are concerned that its flat shape indicates a potential deceleration in economic growth. But the curve is still considerably steeper than it was in the run-up to previous recessions. AB think the shape of the curve has more to do with global quantitative easing. The European Central Bank (ECB) and Bank of Japan (BOJ) are still buying bonds and other financial assets, which helps to offset the Fed's modest tightening and keeps a lid on long-term interest rates. What's more, there's still a tremendous amount of liquidity in the US financial system, and it will take time for the Fed to drain it.

AB think 2018 will follow a different pattern. Yields and inflation may remain low and the US curve relatively flat in the short run. But with the US economy operating at full capacity, AB expect four rate hikes from the Fed—and possibly more if the recently passed changes in US tax policy cause growth and inflation to accelerate more than expected. And with euro-area growth improving, AB expect the ECB to finish tapering its monthly bond purchases in the second half of 2018 and begin raising rates in 2019.

The reduction of monetary accommodation will play out gradually, as central banks move at different speeds. For example, AB expect the Bank of Japan to maintain its policy of capping long-term bond yields. While Japanese growth is improving, core inflation remains well below the central bank's 2% target. In China, policymakers will focus on the quality of growth and strive to rein in excessive leverage, particularly in the shadow-banking system.

This policy variance should create dispersion in rate markets—and opportunity for global bond managers. But investors should monitor their duration risk carefully and be selective about their credit exposure as volatility increases.

Investment Option Commentary

The portfolio increased in absolute terms and significantly outperformed the cash benchmark in the fourth quarter. Sector/security selection drove positive returns, as exposure to investment-grade and high-yield corporates in the eurozone added. Positions in US investment-grade corporates and Japanese inflation-linked securities also contributed.

Country/yield-curve positioning detracted from overall performance. Losses from positioning in Mexico and the US outweighed gains from positioning in Australia.

Currency decisions were also negative for returns. AB's underweight position in the South Korean won detracted, while the portfolio's overweight position in the Polish zloty added.

The portfolio is positioned in accordance with several main themes. AB expect UK and European government yields to rise over the course of 2018. They remain selective in their local EM positioning, in order to benefit from falling inflation and attractive existing real yields. AB expect financials to benefit from an improved fundamental picture and cheaper valuations versus other corporate sectors. AB anticipate that European high-yield credits should benefit from the improving European economic outlook. AB expect high-yield EM sovereign debt to benefit from continued strong inflows and cheap valuations versus US dollar-denominated corporate high-yield debt from DM issuers. Finally, AB believe US dollar-denominated securitized bonds will benefit from wide spreads and an improved US growth outlook.

During the fourth quarter, AB modestly reduced the overall duration of the portfolio to below 2.5 years. They increased their exposure to US duration and maintained exposure to the front end of the curve in Australia, given their view that the Reserve Bank of Australia will continue to keep rates on hold over the next year while DM central banks tighten monetary policies. AB also increased Their exposure to Poland, where spreads to the German Bund curve had widened to favorable levels. Additionally, the investment manager increased exposure to Brazil late in the period after a sell-off in October and November, and reduced their Canadian duration exposure after a recovery versus US Treasuries, in terms of spread. AB increased their short duration position in Europe and trimmed their exposure in the UK, given outperformance versus other markets.

Toward the end of the period, AB took off their euro 5s30s yield-curve flattener, as AB believe increased long-end supply in January could cause the curve to steepen. AB will seek opportunities to put this trade back on in the coming weeks, as the curve remains very steep by historical standards. AB recall that during the US "Taper Tantrum"—the 2013 increase in US Treasury yields after the Fed announced that it would slowly reduce the amount of money it was injecting into the economy through quantitative easing—30-year notes outperformed five- and 10-year notes.

AB have strong conviction that DM yields will rise next year. Importantly, the changing quantitative easing dynamics from various central banks means that in 2018 the market will be met by a positive net supply of government debt for the first time in six years, as the Fed has begun to run down its balance sheet and AB expect the ECB will end its quantitative-easing purchases in September 2018.

The Fund modestly increased exposure to sterling-denominated credits in non-financials and senior holding-company bank new issues. AB also sourced more credit risk-transfer securities, on which they maintain a strong fundamental outlook.

In terms of the fund's current spread-sector exposures, more than half of its spread-sector risk comes from investment-grade and high-yield corporate debt, and just under half of that is in financials. The fund's next largest spread-sector exposure is to EM hard-currency debt—mostly in high-yield rated sovereigns—followed by commercial mortgage-backed securities and agency risk-sharing securities.

In currencies, the fund moved to a short sterling position versus the US dollar to express the more optimistic view AB have of the Fed's rate hike profile in the future. AB also trimmed some of their existing EM longs to move to a long position in Poland. The fund moved to a short position in the yen, as AB believe the BOJ will be the last major DM central bank to begin tightening monetary policy.

AB maintain a constructive outlook on EM in the medium term, but have reduced less fundamentally supported positions, such as South Africa and Turkey. The fund maintain exposure in Argentina, Brazil and Mexico, and added in Poland and Indonesia during the quarter.

Outlook

Global growth remains robust—and seems to be gaining strength and breadth as the trade cycle shifts to a higher gear. As capacity use tightens further, AB expect to see global inflation and wage growth gradually start to rise. At the same time, there are several structural forces that should apply upward pressure to inflation in coming years, including demographics, populist policies and monetary regime shift. AB expect central banks to keep traveling the path of policy normalization, led by the Fed with four rate hikes in 2018. Solid growth means the backdrop for risk assets will remain benign. But risks remain, including geopolitical tensions, the US economy's response to higher rates, and the effect of central bank balance-sheet reduction on asset prices. Entering the new year, AB have revised their 2018 global GDP growth estimate upward a touch to 3.2%. AB also raised their developed-market (DM) GDP growth estimate to 2.3% for 2018, while holding steady their EM growth forecast at 4.6%.

The US economy ended 2017 on a high note, and AB still think that it would take a very large shock to derail the momentum in the near term. As they look ahead to 2018, AB expect the Federal Open Market Committee to tighten financial conditions gradually, with asset prices unlikely to perform as well this year as they have last year. The biggest economic risk on the horizon is higher inflation. Should price pressures accelerate, the accommodative financial conditions that boosted growth in 2017 may prove unsustainable. That said, a modest slowdown into the second half of 2018 is part of AB's base-case scenario for the US and should not be viewed as a negative outcome. With the economy growing above potential, a modest slowdown should serve to prevent overheating and limit financial market instability. The outlook in general is a good one, and AB have revised their 2018 GDP growth for the country up to 2.3%.

With the rise in underlying eurozone inflation likely to be slow and oil prices subdued, AB expect headline inflation to average 1.4% in 2018, a touch below 2017's 1.5%. Still, AB doubt that this will have a material impact on the ECB's confidence that inflation will eventually return to target. Though the central bank is cutting the volume of its monthly asset purchases next year, it has adopted a very dovish communication strategy. While this has helped the market react smoothly to the reductions, the direction of ECB policy is clear. The question is no longer whether it will withdraw monetary stimulus, but how quickly it is likely to do so. Against this backdrop, AB now expect GDP growth in the region to expand by 2.5% next year.

Japan's recent GDP data has confirmed that there is still solid momentum behind the country's economic activity. Accordingly, the output gap continues to close. That's clear, whether we look at survey-based measures of spare capacity or more formal calculations from the Cabinet Office or the BOJ. With the yen at competitive levels, monetary policy accommodative and more fiscal stimulus in the pipeline, it's difficult to see things changing dramatically in 2018. The focus should remain, then, on whether these capacity pressures end up spilling over into higher inflation. Though both inflation and wages (particularly for part-timers) have moved up a bit, they are well shy of levels needed to declare "success" in reaching the BOJ's 2.0% inflation target. For now, AB's 2018 GDP growth estimate for the country remains 1.7%.

In Australia, the schism in economic indicators remains. Business sentiment continues to be robust, with businesses responding by hiring workers at a faster pace, but households are clearly under pressure, with record-low wage growth and weak consumption. AB expect the central bank to stay on hold through 2018, making it a laggard in the global policy normalization process. Their Australian GDP growth forecast for 2018 remains 2.4%.

AB have revised their GDP growth forecast for Canada up to 2.5% in 2018. Growth is still robust and above potential, and employment numbers are improving. Wage growth has started to respond to the tightening labor market, but policymakers still believe that there's more slack in the labor force. These positive data points should imply a more hawkish Bank of Canada. However, there are risks, such as the effect of higher rates on the housing market and consumption, the possibility of increased US trade protectionism and the path of Fed rate hikes.