

Macquarie Income Opportunities

Quarterly Investment Option Update

30 June 2018

Availability

Product name	APIR
AMP Flexible Super – Choice (Retirement)	AMP1585AU
AMP Flexible Super – Choice (Super)	AMP1573AU
CustomSuper	AMP1525AU
Flexible Lifetime – Allocated Pension	AMP1537AU
Flexible Lifetime – Super	AMP1525AU
Signature Super	AMP1549AU
Signature Super – Allocated Pension	AMP1561AU

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: To provide higher income returns than traditional cash investments (with some volatility over short time periods) by investing in a diversified portfolio of both domestic and global credit based securities. The benchmark used is the Bloomberg AusBond Bank Bill Index. The portfolio invests predominantly in floating rate notes, Residential Mortgage Backed Securities (RMBS) and Commercial Mortgage Backed Securities (CMBS), which make up the core portfolio. The investment manager also takes an opportunistic approach to investing in hybrids, global investment grade debt securities, global high yield securities, emerging market debt securities and credit opportunities (such as Australian RMBS, offshore asset backed securities, bank loans and other credit opportunities) which aim to take advantage of dislocated market conditions. International investments are generally hedged to the Australian dollar.

Investment category: Credit and Fixed Interest trading strategies

Suggested Investment Timeframe: 3 years

Relative Risk Rating: Medium

Investment Style: Active

Asset Allocation	Range (%)	Actual (%)
Investment Grade	20-100	94.8
Hybrids	0-10	0.1
Global High Yield	0-15	0.0
Emerging Market Debt	0-15	0.0
Credit Opportunities	0-20	5.1

Holdings

Industry Exposure – Top 5	%
Banks	23.8
Residential mortgage	12.1
REITs	5.8
Non-agency CMBS	4.6
Electric	4.3

Regional Exposure	%
Australia	57.1
United States	21.7
UK	3.0
Europe Ex UK	8.7
Other	9.5

Top Ten Securities	%
Westpac	1.6
NAB	1.3
Bank of America Corporation	0.8
Medallion Trust	0.7
Sun Group Finance	0.7
Lloyds Banking Group	0.6
AGL	0.6
Westpac	0.6
AMP	0.6
Westpac	0.5

Market Commentary

Most markets were flat to modestly weaker over the June quarter – with volatile politics and geopolitics providing much of the fuel for rapidly changing market sentiment.

The receding tide of central bank liquidity is still the key theme to the market backdrop and is driving the increasing number of ‘cracks’ that the Fund Manager is observing. The US Federal Reserve (Fed) has increasingly tapered its re-investment program for both government and mortgage-backed securities, and while the European Central Bank (ECB) announcement in June was accepted as ‘dovish’ it did commit to ending their purchase program by year-end. Deposit growth is also slowing in Australia. These moves have created a tighter liquidity backdrop for the entire world, contributing to developments that are widely visible and increasingly concerning. These range from LIBOR-OIS spread widening, to emerging market weakness, to the sharp repricing of European peripheral bond yields; and the key common thread is the disappearing safety net provided by central bank liquidity.

Increasing trade tensions were the most notable change this quarter. This has been on investors’ minds since Trump was elected US President, but the hardening attitudes of both the US and China, as well as the surprising extension of US trade rhetoric to the EU and Canada has brought the issue front and centre. The US has now announced or placed tariffs on a range

of products and trading partners have, in turn, announced or enacted tariffs on products ranging from US automobiles to soybeans. So far, the tariffs and measures actually put in place have been modest, but the escalating announcements coupled with little apparent progress in negotiations do not paint an encouraging picture for global growth.

European bond markets were spooked by the formation of a Five Star - League coalition government in Italy in May. A plan (later denied) to demand debt forgiveness from the ECB, a proposed Euro-sceptic finance minister, and significant fiscal expansion plans were all judged to seriously increase the risks for European bond markets. The reason for the angst centres around the huge size and influence of the Italian government bond market, being the largest in Europe and intertwined in the region’s financial systems. The volatility had direct implications for Italian banks and corporates, which sold off aggressively, but also peripheral financials and broader European banks.

M&A activity was also a focus, specifically for credit markets. The approval of the AT&T / Time Warner deal in the US creates a telco and media behemoth and opened the gates for Comcast to join the bidding for Fox (against Disney). The common theme through the M&A deals has been a significant increase in leverage – a negative for creditors – but a commitment by management to de-lever in the years ahead and leniency from the ratings agencies. Our tactic of buying into deals post-M&A (where spreads are more attractive, and the M&A news is out of the way) continues to work, however, the Fund is increasingly wary of the broad acceptance of leveraging transactions in the current market backdrop. Balancing this, corporate earnings overall remain very strong, with over 75% of US companies beating earnings expectations for Q1 and YoY earnings growth of almost 20% tipped for Q2.

Investment Option Commentary

The local AUD credit market outperformed versus global credit markets, as there were much fewer new issues in the Australian market. Benchmark US investment grade spreads widened another 15bps over the quarter, compared to Australian spreads which widened by less than half that amount. Emerging markets (which the Fund holds zero exposure to) were the hardest hit on geopolitics, lower liquidity and a stronger US dollar, with spreads widening by 70bps on average.

Amongst industry allocations, holdings of US CMBS securities (within the Credit Opportunities allocation) were a strong positive contributor to performance, as spreads here stayed stable amidst broad credit market weakness. Mortgage-backed securities also added value for the same reason. Holdings of longer-dated banks securities, however, detracted, as flatter interest rate curves subdued investor hopes for better earnings out of the sector.

Outlook

Recent months have brought several negative events, which the Fund Manager links together through the lens of underlying tightening of liquidity conditions as central banks slowly withdraw their support. These rolling concerns have included LIBOR-OIS spread moves, emerging markets, peripheral European bonds, and China. Fundamental growth indicators remain solid but technical considerations continue to weigh on market sentiment. The backdrop of withdrawing central bank liquidity and support is a key common factor and will be an underlying influence for the foreseeable future.

From a fundamental point of view, growth momentum remains solid, particularly in the US. The Fund remains mindful that a significant repricing of bond yields, or sharp withdrawal of stimulus could undermine risk asset pricing. Sharp changes in

sentiment are probably likely in the coming months as evidenced by the moves in China this quarter. There remains clearly less room for error in case of a slowdown or policy mis-step. As a result, the Fund Manager believes there are opportunities to continue to participate in market performance but with an eye to gradually managing risk levels downward as spreads tighten. For now, solid growth momentum and corporate earnings provide a robust basis for participating in credit market performance.

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